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SPECIAL REPORT

THE NORDIC PROPERTY MARKET

Investment and funding

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ON FIRM FOUNDATIONS

With a track record of regular growth, the Nordic property sector presents an attractive destination for investors. High quality assets and political stability suggest that the environment will remain a good risk for the foreseeable future. Sverrir Thór, the editor, economics and finance, Fastighetsnytt, *reports.*

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When it comes to investment in property, the Nordics are an attractive option – regardless of whether this is direct or indirect exposure to the asset class and the region. Over the decade ending on March 30, 2018, the Nasdaq index for the Nordic property sector had increased with an average annual rate of 13.6% (total return). In the single largest of the Nordic markets, Sweden, the index has risen by an additional 0.3 percentage points.

And while what goes up must eventually come down, there are few signs that this will happen any time soon. The market is made of professional players with good knowhow in both property management and in finance.

Similarly, asset quality is generally high and there seems to be an insatiable demand for new space to let, in both the office and residential rent segments. Finally, the price of money – which is perhaps the most important of all inputs in the modern property industry – is expected to remain low for a long time to come.

GOOD FUNDAMENTALS

To add to that there is a strong underlying economy, political stability and a level of corruption lower than in most countries – indeed, the Nordic economies frequently top the lists of low-corruption countries. Thus, fundamentals indicate that the region's property industry will remain prosperous for the coming years – but of course there are challenges.

Economic fundamentals can change fast, resulting in falling demand, and interest rates could start rising more rapidly than planned. These are perhaps not improbable events but are manageable as they have a cyclical element. A riskier – and in the short term, harder to manage – event might be a sudden capital drought. The property industry by its nature is highly capital intensive and while cash-flow generation is the main objective of operation, it is important to have working channels to secure capital, both for the development of new projects but also to maintain existing property.

When Lehman Brothers collapsed and the credit crunch went from being a local to a global phenomenon, Nordic banks tightened the screws. The Nordic banking sector was highly exposed to property and from a risk management perspective it was important to reduce that exposure. As a result, the sector started steering its funding away from being almost solely provided by banks to the money market – and, more specifically, the corporate bond market.

FUNDAMENTALS INDICATE THAT THE REGION'S PROPERTY INDUSTRY WILL REMAIN PROSPEROUS FOR THE COMING YEARS – BUT OF COURSE THERE ARE CHALLENGES

BOND PRESENCE

Today, most larger Nordic property companies have a healthy presence in the bond market – some might argue that it is becoming a bit too healthy. In the Swedish money market, for example, almost half of the outstanding volume of bonds has been issued by property companies.

While most issuers are robust companies with stable cash flows and are nowhere near the risk of becoming insolvent, this has created the need for larger issuers to enter foreign markets. So far, most of the bonds denominated in foreign currencies have been issued in euros (although some companies have also entered the sterling market) and there is more supply to come.

Based on historic performance, the case for indirect exposure to Nordic properties is strong – through equities as well as funds and fixed income – and as the number of companies entering the international markets increases, the number of opportunities to invest in Nordic property markets will only grow further. TB

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Bricks and mortar: Finland's Citycon invests in urban shopping centres

WILL EQUITY MARKETS MAINTAIN THEIR HOT STREAK?

Property companies in the Nordic region have favoured the equity market recently as investors responded to low interest rates. Can the outlook remain positive despite Sweden's declining house prices? Stefanie Linhardt reports.

Nordic real estate companies have been blessed with strong growth and returns since the financial crisis. Indices such as the Carnegie Real Estate index have doubled in value in the past five years. But can this performance last? House prices, which have been rising over the past six years, especially in Sweden, fell by about 10% between September 2017 and February 2018. Is this having an impact on the commercial real estate sector? What are the key drivers of real estate performance?

"Normally, I expect 10% total performance per year on my portfolio, but the average in the past five years has been 20% per year," says Jonas Andersson, lead portfolio manager of Alfred Berg's Fastighetsfond Norden, a fund investing in Nordic property stocks. "I target more than 10% going forward for 2018 and 2019."

Mr Andersson calculates the "more than 10%" on a company's net asset value level as a cashflow yield of 6% plus a 2% value growth at an average leverage level of 55%, which doubles the impact of the property value increase. "But that is based on a 2% value growth – I assume values to grow even more," he says.

KNOCK-ON EFFECTS

But how do these expectations square with the fall in house prices, especially in Sweden?

"There are quite important differences between the drivers of the housing market and the commercial real estate side," says Anna Breman, chief economist at Swedbank. "The correction in the housing market on the non-commercial side has really been a side-effect of regulatory changes, higher levels of construction and hence more supply in the market, and it is mainly driven by the largest cities."

Ms Breman adds that in the commercial real estate market, low interest rates, »

THERE ARE QUITE IMPORTANT DIFFERENCES BETWEEN THE DRIVERS OF THE HOUSING MARKET AND THE COMMERCIAL REAL ESTATE SIDE ***Anna Breman***

global growth in general and domestic economic expansion, as well as a growing business sector, play more of a role when analysing the performance of the real estate segment. Additionally, there have been no significant regulatory pushes or increased supply that could affect the market negatively.

NOT JUST REAL ESTATE

Yet, despite the historically strong performance of real estate equities in the Nordic region, many listed companies are currently trading below net asset value, according to Max Barclay, head of Sweden-based full-service property house Newsec Advisory.

As Pangea Property Partners' real estate-specific indices show, the Nordic retail sector has been hit particularly hard in 2018. In the first 16 weeks of the year, the company's PREX Retail index is 8.2% lower, while construction (-0.9%) and mixed real estate (-0.1%) have also underperformed, pushing the overall PREX Property index down 0.5% in 2018 to date.

Company and sector selection is, therefore, crucial for investors. Alfred Berg's Mr Andersson, for example, is underweight on retail-exposed real estate companies and favours those renting out offices, a sector in which the Pangea index has increased by 1.2% in 2018 to date.

"Stockholm is super hot. Here we have seen the highest percentage increase for office rents," he says. "There has been a shortage in new office space, while the demand is increasing, so rent levels are booming."

Vacancy rates in the Stockholm office sector are very low at 2.5%, compared with 5.4% in Oslo, 6.8% in Copenhagen and 6.9% in Helsinki, according to Swedbank research. The bank predicts that office rental growth in Stockholm will slow down.

SWEDEN'S SURGE

From a macro-economic perspective, the recent rapid increase in the Swedish population from 9 million to 10 million in 2017 and expectations of 11 million inhabitants by 2025, will also have an impact on the real estate industry, according to Ms Breman.

"Given that you have this high population growth in Sweden, there is a lot of need for investment into real estate that is focusing on the public sector: schools, daycares and elderly care," she says. "These demographic factors are supporting the commercial property market."

According to research from Pangea, the outlook is positive for both offices and logistics, slightly positive for the public sector and neutral for the residential and hotel real estate sectors, while the retail outlook is slightly negative, although there is a "large difference" between prime and secondary retail.

"The retail real estate market has been punished far too much by stories of mall closures in the US, which are not comparable with Europe," says Marcel Kokkeel, chief executive at Finland-headquartered retail real estate development company Citycon. "In the US, you can copy any store and you can build it anywhere. At Citycon, we are investing in urban shopping centres, which are uniquely integrated with public transport and offer community services such as libraries or walk-in medical services."

FOCUS ON THE CORE

Citycon, which started out as a Finland-focused business, has over the past five years trebled its equity and broadened its exposure geographically to become a pan-Nordic company. It now looks to divest its assets in smaller cities to focus on the Nordic capitals.

"We now have relevant size, which allows us to focus on investing in the assets we have, to make them better and have them work better for the community," says Mr Kokkeel.

Companies such as mixed real estate businesses Kungsleden and Castellum are following similar strategies, which see them sell assets outside their key focus areas while further consolidating their portfolios.

The fourth largest Nordic property company, Hemfosa Fastigheter, meanwhile, is in the process of splitting its operations into two: Hemfosa, which will remain listed and retain the company's public sector real estate portfolio, and Nyfosa, which will act as an "agile and transaction-intensive property company", according to current Hemfosa chief executive Jens Engwall, who will take over the helm at Nyfosa once the split has taken place.

The plan is for Nyfosa to also be listed by the end of the year, which is expected to happen through a stock split, giving current Hemfosa shareholders shares in both companies.

MORE SUPPLY?

Property companies flocked to the equity market between 2014 and 2016 because more investors were seeking to invest in property stocks, given the low interest rates and low returns that were available in the bond market.

"Everyone from the bus driver to smaller and larger institutions all showed a lot of interest in investing in real estate stocks," says Newsec's Mr Barclay. "This is still the case, but the interest in direct investments is also increasing."

He notes that the businesses now looking to enter the equity market are largely single-asset companies, which have been set up as special-purpose vehicles.

In 2018, the only ordinary share issues recorded by Pangea Property Partners were a SKr1.01bn ($118m) rights issue by D Carnegie to finance acquisitions in Stockholm and Västerås, and a listing by Cibus, a portfolio of assets divested by Finnish investor Sirius on Stockholm's First North exchange for smaller businesses. In the past 18 months, there has only been one initial public offering on the main exchange, for mid-sized Swedish developer SSM in April 2017.

The weaker pipeline for equity capital market deals goes hand in hand with a growing focus on direct investments by Nordic and international institutional money and private equity funds (see article on direct investments on page 73).

FIGHTING OFF PRIVATE EQUITY

The recent takeover offer by US private equity investor Starwood Capital for Victoria Park, the sixth largest stock exchange listed property company in the Nordics, is a case in point – and it underlines a trend of international private equity money targeting listed businesses.

In the case of Victoria Park, the board has recommended to decline the offer. So, especially at a time of lower valuations, are hostile takeovers something other businesses need to be wary of?

Ilija Batljan, chief executive at SBB Norden, a Stockholm-based business with a focus on public sector rentals, believes so. "I think all of us need to look at and analyse what kind of consolidation opportunities there may be," he says. "Otherwise you might just wake up one day and someone is buying you out of the market."

A typical way to lower the share price discount to net asset value would be to buy back some of the outstanding shares, according to Mr Andersson at Alfred Berg. He points to residential and office real estate business Wallenstam, which has a buyback programme but is using it mainly as a complement to paying a dividend.

Other options include mergers and acquisitions (M&A) among the existing players.

"Valuations and share prices might provoke M&A," says Citycon's Mr Kokkeel. "We are keeping our eyes open. If there was an opportunity that was good for shareholders, we would explore it."

At times of increased investor demand and after several years of record returns, the question arises: how much longer can such a market environment last? And where is the property clock, or cycle?

FIVE TO 12?

"If you had asked me this time last year, I would have said the same thing as today," says Mikael Söderlundh, head of research and partner at Pangea Property Partners. "We are high in the cycle. Not at the peak yet, but quite close to it in Sweden, with the other Nordic countries perhaps a year behind."

Pangea expects international investors, institutions and property funds in particular to further increase their exposure to Nordic real estate in 2018.

But as with differences in performance between the different real estate segments, distinctions might be necessary when analysing the cycle for property as a whole.

"There is a difference between real estate companies focusing more on the needs of the public sector, which is more structural, as the need for daycare, elderly care and schools is not going to slow down in the near future," says Swedbank's Ms Breman. "But other sectors like office space are more mature and will heavily depend on global growth developments."

According to the JLL Property Clock for the office sector, as of the first quarter in 2018, Oslo is at about 7.30, still with scope for accelerating rental growth, Helsinki and Copenhagen are at 9, while Stockholm is at about 10.30 (see graph, above right).

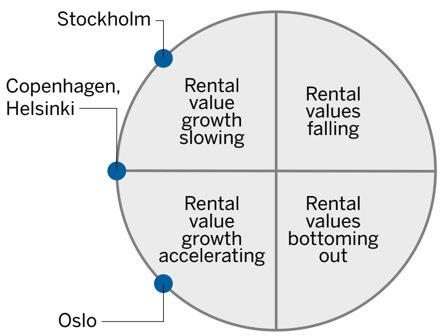
"One thing that could cool the market down in Sweden is the new amortisation rules, which were introduced on March 1 this year," says Mr Söderlundh. However, those have a greater impact on owner-occupied properties. Mr Söderlundh adds that the general elections in September as well as the introduction of interest rate deduction rules later in 2018 could have an impact on the real estate market, too.

Yet the most important factor will remain interest rates, and with them companies' costs to finance themselves (see articles about fixed income and bank lending on pages 77 and 80, respectively).

And while expectations are for an increase in rates at the back end of 2018, the step change is likely going to be slow in coming. Ms Breman expects hikes to be very gradual and only of 10 basis points as a first step, which should mean interest rates, at least in Sweden, remain at zero for the course of 2019.

So the cycle will turn at some point, but likely not in the next couple of years. TB

Nordic office property clock, Q1 2018



Source: JLL

THE DIRECT APPROACH

Private equity funds are expressing ever-greater interest in the Nordic property market, and listed companies are next on their shopping list, writes Stefanie Linhardt.

WE HAVE SEEN COMPETITION GOING DOWN, AS WIDESPREAD UNCERTAINTY AROUND RETAIL PROPERTIES MAKES IT MORE DIFFICULT TO GET FINANCING FOR NEW INVESTORS, WHILE THIS IS NOT A PROBLEM FOR US ***Lennart Sten***

INTEREST IN DIRECT INVESTMENTS in Nordic real estate is growing, especially from international investors. Large institutional investors looking for geographical diversification often choose local property funds to manage their money, and competition from pension money is strong.

"In the Nordics, and in particular in Sweden, a lot of pension money owns many of the core properties in the major cities," says Helena Olin, head of real asset investments at the Second Swedish Pension Fund AP2. "That can make it hard to compete for some newcomers. For some international investors, it still is a small market, but looking at return figures, they should have already been here a few years ago."

In specialised areas in particular, it can be difficult for investors to enter the market, for example in retail parks, where real estate company Svenska Handelsfastigheter operates.

"We have seen competition going down, as widespread uncertainty around retail properties makes it more difficult to get financing for new investors, [though] this is not a problem for us," says the company's chief executive Lennart Sten.

ON THE LIST

Nevertheless, international private equity funds are increasingly pushing into the Nordic property market.

"There is a lot of interest from international investors in Nordic real estate, especially in direct investments," says Max Barclay, head of full-service Swedish property firm Newsec Advisory. "But the individual deal sizes are still too small, so investors are turning to buying listed companies."

The approach by US investment house Starwood Capital is a prime example. In early April, the investor in global real estate made a bid to take private Victoria Park, the sixth largest Nordic property company by market capitalisation, as of trading data on March 29.

The private equity fund has locked in 31.5% of the shares and communicated that it needs at least 35% approval of its offer to go through with the purchase, according to Mikael Söderlundh, head of research and partner at Pangea Property Partners, which advises Starwood. However, Victoria Park's board have recommended shareholders not to accept the deal. The acceptance period ends at the end of May.

"If you would like to invest €2bn or €3bn, you can do this slowly by adding assets or quickly," says Mr Barclay. "But as the stock market is trading at a discount, we will probably see more mergers, larger deals and take privates in the near term."

Another big firm with big plans in the Nordics is US private equity fund Blackstone. One of the buyers behind the largest takeover in the sector in 2017, Blackstone, together with local fund Areim, acquired all shares in Finnish retail and office owner, leaser and developer Sponda for an estimated €3.8bn, before delisting the company.

Among other transactions, Blackstone also sought to buy out the shareholders of residential property owner and developer D Carnegie in 2016, and as of the end of 2017 held 64% of the voting rights in the business.

"The region is one of the wealthiest in Europe, with growing populations, strong urbanisation trends and a liquid and transparent real estate market supported by significant domestic and international capital," says James Seppala, head of European real estate at Blackstone. "Our €7bn office, retail, residential and logistics portfolio continues to perform strongly and we look forward to investing further in the region."

Advisories are reacting to the international push. To serve this growing market and potential new client base, Newsec is looking to set up an office in London, which is expected to open at the back end of 2018.

A CURRENCY PLAY

According to Pangea Property Partners research, the most active investors looking to add Nordic real estate exposure in 2018 are institutional investors, property funds and international investors. According to Pangea's Mr Söderlundh, cross-border transactions in particular have been picking up.

"Net we have seen almost €10bn of cross-border investments in 2017 and expect this trend to continue this year," he says. "We have never seen such a high number before."

Some of this money is related to pan-Nordic cashflow, but about 60% comes from outside the region, notably Germany, the UK and US. "For a lot of Anglo-Saxon investors, the local currencies in the Nordics are quite attractively valued," says Mr Söderlundh.

FIXED INCOME: THE NEXT GENERATION OF FUNDING

Nordic property firms' affinity for the bond market has accelerated in recent years. Danielle Myles investigates why.

Over the past five years, property companies across Europe have increasingly turned to the debt capital markets, but nowhere is this trend more pronounced than in the Nordics. The numbers say it all. Real estate firms were behind some 43% of the region's Swedish krona-denominated corporate bond sales in 2017, according to Swedbank, and now account for more than 40% of outstanding Swedish corporate paper.

Issuance from Swedish firms alone soared from some SKr10bn ($1.17bn) in 2010 to nearly SKr70bn in 2017, while their Norwegian peers nearly doubled their bond sales between 2015 and 2017. "Real estate companies are starting to issue to a larger degree in the bond market, rather than only relying on loans as their primary source of financing," says Tomas Lundquist, Citi's head of European corporate debt capital markets. "It's a trend that has taken off and I have a feeling is likely to be the case for years to come."

As issuance is dominated by the large, listed Swedish property managers, most real estate bonds are investment grade. Indeed, it is these players that have driven the historically small Swedish krona bond market's transformation into a self-sustaining market. Only about 20% of the sector's outstanding bonds are high yield, having been sold by property developers and sub-investment-grade managers.

PERFECT BUSINESS SENSE

The primary reason why Nordic property managers are tapping the capital markets is to diversify funding, reduce their historical reliance on secured loans, and spread counterparty exposure. Bonds and commercial paper now account for about 40% of some of the bigger firms' debt stack. According to the Riksbank, the Swedish central bank, as of May 2017, Swedish commercial real estate companies had SKr456bn in bank debt and SKr344bn in bonds and certificates.

It is undeniable, however, that robust market conditions are a major drawcard. Since regional interest rates hit record »

Liquidity in the Swedish market has been incredible. It has seen very positive fund flows since a few months into 2016
Michael Johansson

lows and the European Central Bank started its corporate bond-buying programme, firms have been able to sell bonds with extremely low coupons. Furthermore, while Nordic banks now require interest rate floors in their loans, investors are happy to live without them.

"Currently it is cheaper for us to borrow via an unsecured bond than a bilateral loan for which we must put up collateral," says Arvid Liepe, chief financial officer at Swedish property company Wihlborgs Fastigheter. "Also, an unsecured medium-term note [MTN] programme is a practical instrument to work with – the flexibility is reasonably high and the administrative cost relatively low."

While most European investment-grade notes are fixed rate, Swedish property managers issue a large portion of their bonds as floating rate. Tenors are about five-years – which is similar to what the banks offer – and in Sweden the vast majority of bonds are unsecured. Compared with secured bank loans, this makes it easier for firms to sell properties to improve rental yields. It is notable that in Norway, however, most of the sector's investment-grade issuance is secured.

BUY-SIDE UNIVERSE

Unconventional monetary policy, having sparked the buy-side to seek out new investment opportunities, such as Nordic real estate, is one reason why the sector's bonds are regularly oversubscribed. But it is the not the only reason. There are fundamental shifts happening within the investor base that indicate the buoyant market will continue after rates rise and central bank bond-buying comes to an end.

First, the buy-side is moving some resources away from industries that dominated bond volumes in the early 2000s – such as utilities and telecoms – and into those driving today's market. "We sometimes meet investors who used to cover utilities, or other sectors, but now cover real estate," says Mr Lundquist. "It seems the investor base is repositioning some of its team to reflect market volumes and opportunities."

As a result, the buy-side is expected to develop a more nuanced appreciation of the characteristics of each sub-sector, be it retail, commercial, residential or logistics. "Today, many investors talk about real-estate as if it is one sector. But they will, and it's important that they do, start to get a more granular understanding of which segment the company operates in," says Mr Lundquist.

Second, debut deals have been snapped up, with the number of property issuers in the Swedish krona market increasing by more than 30% over the past two years. "Investors' willingness to accept new names has also contributed to the very strong market," says Mathias Leijon, Nordea's head of corporate and investment banking. It shows investors will support a growing issuer base.

Finally, Sweden's strong economic growth and financial stability has prompted investors to up their exposure to the country. "Liquidity in the Swedish market has been incredible," says Michael Johansson, a credit analyst at Swedbank. "It has seen very positive fund flows since a few months into 2016, and the larger buyer base has obviously helped them to issue at tight levels."

Furthermore, while Swedish investors do venture beyond the Nordics, they tend to gravitate to familiar names from their home market. "You have a Swedish investor base, particularly the Swedish krona portfolios, that really take a lot of comfort in primarily Swedish names, and also Nordic names more broadly," says Derry Hubbard, Danske Bank's global co-head of debt capital markets.

SECTOR RISKS

Investors are, however, being advised to watch some sector-specific risks. After a decade-long surge in Sweden's and Norway's house prices – which had sparked warnings from multilaterals, rating agencies and analysts as potential bubbles – both markets experienced corrections in late 2017 and early this year. This has hit the price of tenant-owned apartments and some of the smaller developers building them, but market participants agree there has been no direct and immediate impact on residential property managers.

"Sweden's rental market is regulated, the vacancy risk is close to zero and it takes some time for any price development to fully flow through the cashflow-based valuation models," says Mr Johansson. "So for the managers, certainly at the outset, the direct effect should be quite limited."

Another issue is the sector's relatively short debt maturity profiles. Many firms are regularly refinancing, which creates liquidity risks plus other potential problems. "Many property companies are rolling over secured bank debt annually or with two- to three-year maturities, while they reduce their reliance on loans by looking more to the bond market," says Fredric Liljestrand, a director in Fitch's industrials and real-estate team. "If the bank debt matures before the bonds, the bonds become temporally subordinated."

According to the principle of temporal subordination, any debt that is payable before the bonds – irrespective of their respective rankings – becomes more senior.

BROADENING HORIZONS

Naturally, real estate issuers have initially focused on the local Nordic markets, but there is a nascent trend of firms looking to foreign currencies. A handful of Swedish names, including Akelius, have issued Eurobonds and bankers expect the trend to continue. To date, firms with purely domestic portfolios have steered clear of international issuance as it would create foreign exchange (FX) risk. But for those managing assets in other countries, international bonds are a way to currency match; by borrowing in the same currency in which they hold assets, they reduce their FX risk.

Another advantage of Eurobonds is the ability to raise larger tickets than in the Nordic markets, and for tenors of up to 12 years. It is a way to significantly lengthen debt maturity profiles – particularly useful for real estate companies as it allows them to match their long-term portfolios with long-term financing.

Due to managers' historical reliance on secured bank loans, local markets have become a vital stepping stone to issuing a Eurobond, not only as a form of financial education, but also as a way to unencumber portfolios. This is important for two reasons.

First, international investors generally are not willing to hold the only unsecured slice of an issuer's debt stack, as it means they rank subordinate to every other creditor. Local investors are less concerned about this, which makes selling domestic unsecured bonds – and using the proceeds to repay secured bank loans – an ideal way to get balance sheets in shape for a Eurobond.

Second, reducing the proportion of secured financing is necessary to convince rating agencies that they are investment grade. "Once they have a more balanced portfolio of secured and unsecured debt, it has become possible for them to get a rating that doesn't penalise them for the secured debt," says Mr Lundquist. "This makes it easier for them to issue bonds internationally."

RATINGS ENTER A NEW ERA

Kungsleden is a case in point. Last September, Moody's rated the Swedish company Ba1, and affirmed that at least 30% of its properties must be unencumbered for it to be lifted one notch to investment grade. It has since worked towards that goal by reducing its portion of bank loans, and launching and issuing from a SKr5bn MTN programme. As at the end of March, 26% of its portfolio was not pledged as collateral. Its CEO, Biljana Pehrsson, says the company will consider issuing a Eurobond after it receives an investment-grade rating.

The Moody's assessment was Kungsleden's first official credit rating, and it has already paid off. "The rating has enabled us to reduce the cost of our bond financing by roughly 30 basis points [bps] to 40bps," says Ms Pehrsson. She expects to see a similar reduction again after it has reached investment grade.

The reason why Kungsleden and many other large Nordic corporates have only just received their first official rating is because they have historically relied on so-called shadow ratings. These are free assessments made by Nordic banks using the rating agencies' criteria, which was accepted market practice until late 2016 when the European Securities and Markets Authority warned it would clamp down on the process. Today, the only major Nordic bank to still offer shadow ratings is SEB.

HEDGING AND GREEN SHOOTS

Managers hedge their interest rate risk via local swaps, however Mr Johansson's research shows that the sector's average maturity for these hedges has not been extended in recent years. "This is understandable given they've paid to fix their interest rates, but haven't got a lot out of it as rates haven't risen as some experts forecast," he says. "If rates look like they will go higher, they might start thinking about pushing out their maturities again."

Another reason Swedish firms have stepped back from interest rate swaps is because negative interest rates have created a mismatch with the loan market. "Bank loans are floored at zero – so we don't benefit from the negative Stockholm Interbank Offered Rate [Stibor] – while swap agreements aren't. It means we are actually paying more on our swap agreements than if Stibor was zero," says Ms Pehrsson.

In a separate development, Nordic real estate firms have implemented world-class sustainability frameworks and have been very active in the green bond market. "Sweden is still the region's biggest market but interest is increasing rapidly in Finland and Norway, and Denmark is starting to pick up, too," says Einar Erici, a director in Nordea's debt advisory division. "It means tapping into another pool of capital, and the price they pay is 2bps to 4bps lower than a conventional bond." Indeed, the sector is a leading example of how issuers can lower their borrowing costs by selling green bonds. TB

WE ARE ACTUALLY PAYING MORE ON OUR SWAP AGREEMENTS THAN IF STIBOR WAS ZERO ***Biljana Pehrsson***

WHY LOANS RETAIN A REAL LUSTRE

While Nordic firms are using more bonds, and are keen to diversify their funding base, their preference for bank loans in the real estate sector shows little sign of waning, as Danielle Myles discovers.

THE BOND MARKET IS STRONG NOW BUT IF THAT CHANGES, AND YOU NEED TO REFINANCE, IT'S MORE DIFFICULT TO DO THAT WITH A BOND THAN A BANK WITH WHICH YOU HAVE A LONG-TERM RELATIONSHIP

Susann Linde

THE NORDIC PROPERTY MARKET is among Europe's biggest, but when it comes to funding it is also one of the most traditional. While the UK sector, for instance, relies primarily on unsecured bonds, bank loans are still the mainstay of Nordic debt stacks.

As listed property companies – particularly those in Sweden – become more financially sophisticated, they are turning to bonds. But their finance chiefs do not see the capital markets displacing loans as their main funding source any time soon. "The bond market is strong now but if that changes, and you need to refinance, it's more difficult to do that with a bond than a bank with which you have a long-term relationship," says Susann Linde, chief financial officer at Gothenburg-based property company Wallenstam.

They also value the loan market's stability. Arvid Liepe, chief financial officer at Swedish property firm Wihlborgs Fastigheter, says: "To my mind, bonds are probably more volatile and higher risk. If the market moves into a crisis-like situation, the bond market is more likely to be closed than the bank market."

MOTIVATING BY PRICING

A key reason that larger operators have issued bonds is pricing. With regional interest rates at record lows, it is cheaper for them to sell an unsecured bond than borrow from the banks, which invariably require collateral. Yet banks can be the most cost-effective option for smaller and lower rated firms, for whom bond prices can fluctuate dramatically.

A typical loan to the sector has a tenor up to five years, is at a floating rate and, as of recent years, has an interest rate floor of zero. The floor has proved problematic in countries with negative rates, such as Sweden, because hedging contracts are not floored. This has led to a perverse outcome whereby firms today have higher interest costs than if the Stockholm Interbank Offered Rate (Stibor) were zero.

"I understand the banks don't want to end up in a situation where they pay the borrower, but a Stibor floor is illogical in that they don't exist in the interest rate swap market," says Mr Liepe. "Between the floor and Stibor being negative, we end up paying in both legs of the swaps."

There are recent examples of banks agreeing to remove Stibor floors, but lenders' ability to compete on price is restricted by other obligations. "In part, it's because of the equity ratios and return requirements the banks have to their stakeholders," says Dag Fjeldstad, client manager of real estate and construction in DNB's large corporates segment. "There is a limit as to how low banks are willing to go with margin, even for the best of credits."

CREATING HEADROOM

Bank appetite for Nordic property exposure has varied over time, but both borrowers and banks see no shortage at present. "We don't see access to credit as an obstacle," says Mr Liepe.

Volumes have been muted, but the borrower mix has changed thanks to the capital markets rush.

"Lately, it seems that some of the larger companies issuing bonds rather than loans has increased the availability of bank financing for smaller companies," says Swedbank credit analyst Michael Johansson.

Mr Fjeldstad concurs, adding: "We see this as a desirable development. It's part of our policy to assist the smaller, non-investment grade companies that may not be able to tap into the capital markets."

Lending has traditionally been on a bilateral basis, but bankers say this is evolving. "Lately, there has been an increasing tendency towards club deals or syndicated deals, particularly for the larger facilities. Those deals tend to be with other Nordic banks," says Olav Løvstad, head of real estate and construction in DNB's large corporates segment.

Firms with properties in Denmark benefit greatly from the Danish mortgage system, which recognises commercial property as eligible collateral for covered bonds. They can borrow from the country's mortgage institutions at bond market rates for tenors of up to 30 years.

A QUESTION OF VALUE

When compared with the rest of Europe, Nordic property companies tend to operate with higher loan-to-value ratios. Stefanie Linhardt looks at why this approach works in the region.

Before the global financial crisis, Nordic property businesses used to operate with high loan-to-value (LTV) ratios. While leverage has decreased from what was then often normal levels of some 70%, Nordic real estate businesses still operate with comparably high LTVs on the international stage. But how and why does it work?

"As an investor in the stock market, you get higher returns on leverage, so I like it, because it means that I can get a better performance," says Jonas Andersson, lead portfolio manager of Alfred Berg's Fastighetsfond Norden – a fund investing in Nordic property stocks. "If it's a stable company I can live with high leverage but I want loan-to-value levels to be well in line with what the banks are comfortable with."

In Sweden, banks are broadly looking for about 55% – any higher and it costs more, adds Mr Andersson. In the Norwegian market, average LTV levels for commercial real estate companies are about 60%, but can rise to about 65% depending on special factors, according to Dag Fjeldstad, client manager of real estate and construction in Norwegian financial services group DNB's large corporates segment.

HOW MUCH IS TOO MUCH?

SBB Norden, a Swedish business with a focus on lower risk rental properties, had a slightly higher than average LTV of 60% at the end of 2017, according to chief executive Ilja Batljan. However, this figure has come down from more than 70% at the end of 2016.

"Ninety percent of our income comes either from government or from regulated residential real estate, which means that our exposure actually is to the Swedish and other Nordic states," says Mr Batljan. "From that point of view we should be able to have an even higher LTV ratio."

From a bank perspective, this would not be a problem, Mr Batljan notes, as "they are often open to have LTVs for regulated residentials of 70%".

"Banks are much more aware when it comes to segmenting the sector, to look at you differently depending on if your properties are retail, office, prime office or regulated public properties," he says. "Our LTV at 60% really is comparable with an LTV at 50% for commercial real estate."

A RISK FOR BOND INVESTORS?

As Nordic property companies are increasingly turning to the local and international bond market, could these LTVs turn into a problem for bond investors?

"We believe that a rise in interest rates, even if gradual, could put pressure on the financial risk profile of these companies given their capital-intensive nature," says Marie-Aude Vialle, director at S&P Global Ratings. "Higher interest rates could not only lead to weaker interest coverage ratios, which could be an issue particularly in low-yielding markets such as residential in Sweden, but also negatively affect asset valuations, pushing leverage ratios up, and closer to covenant levels for some issuers."

Yet recently, the trend has been more towards a contraction in LTVs. According to Swedbank's Nordic Real Estate Sector 2017 recap and 2018 outlook published in March, only seven out of 35 businesses increased leverage in 2017, while Humlegården's LTV was the lowest at below 40%.

SBB Norden is also looking to further lower its LTV ratio, as Mr Batljan aims to improve the company's BB rating to investment grade. He intends to achieve this, like many of his peers, through an increase in valuations. Some companies also raise equity to grow and lower their leverage, such as Citycon, which gradually brought its LTV down from 58% to 46% over a seven-year horizon, according to chief executive Marcel Kokkeel, giving it a BBB rating (see article on listed Nordic real estate companies on page 73).

"Leverage levels are getting a bit more prudent and are going down to below 50% among core companies," says Helena Olin, head of real asset investments at the Second Swedish Pension Fund AP2. "This might still be a bit higher compared with some of Europe, where levels are below 40%, but values in Paris or London are more volatile historically, so you might say it is fair to have slightly higher leverage levels [in Sweden]."

LEVERAGE LEVELS ARE GETTING A BIT MORE PRUDENT AND ARE GOING DOWN TO BELOW 50% AMONG CORE COMPANIES ***Helena Olin***

NORDIC FX: VOLATILITY AHEAD?

The Nordic countries' currencies are renowned for stability and low risk, but concerns are surfacing around the currencies of Norway and Sweden, nicknamed the 'nokkie' and the 'stocky'. Joy Macknight reports.

A COMMONLY HELD VIEW IS THAT, AT CURRENT LEVELS, AN INVESTOR ISN'T DOING THAT MUCH WRONG IF THEY DECIDE NOT TO HEDGE

Magne Østnor

Managing different currencies adds some complexity to operations spanning the four largest Nordic economies, which are similar in business, legal and sociopolitical aspects. However, foreign exchange (FX) risk is lessened due to Finland's use of the euro and the Danish krone's close peg to the common currency.

The Danish currency keeps within an exchange rate band agreed by the country's central bank, Danmarks Nationalbank, and the European Central Bank (ECB), and is the cornerstone of the country's economic policy.

"The central bank keeps a tight rein on the krone and will intervene if it gets too strong or weak," says Jørn Sodborg, director, head of e-business and distribution at Jyske Bank.

He adds: "After the Swiss National Bank unpegged the franc in January 2015, speculators thought the Danish krone would follow. But the Nationalbank acted aggressively in the market to defend the currency, which won it well-deserved credibility." Thus, speculators are not active in the Danish currency market; instead, activity is mainly linked to mergers and acquisitions and hedging by pension funds, asset managers and corporates.

NOKKIE AND STOCKY

The Norwegian krone, or 'nokkie', and the Swedish krona, or 'stocky', are the liveliest of the Nordic currencies. Today, they are both on the weak side compared with the euro, according to Richard Falkenhäll, senior FX strategist at SEB. Sveriges Riksbank moved to weaken the stocky to support Sweden's export-driven economy, whereas the nokkie weakened due to plunging oil prices in 2014. Notwithstanding some volatility, Mr Falkenhäll reports that 'real money' investors – such as pension funds and asset managers – commonly do not hedge, and operate with an open FX exposure.

Before the global financial crisis, it was usual to see long hedges in stocky, he says, as exporters hedged future revenues. "But during the crisis their order books disappeared and they ended up being over-hedged, which was costly. Since then, domestic companies now hedge less and for shorter time periods than historically," says Mr Falkenhäll.

Magne Østnor, FX strategist at Norwegian investment bank DNB Markets, says real money investors, with a three- to five-year horizon, may use FX forwards and options, but concurs that many long-term investors do not typically hedge FX risk.

"A commonly held view is that, at current levels, an investor isn't doing that much wrong if they decide not to hedge," he says.

Real estate company Samhällsbyggnadsbolaget (SBB) de-risks its business by holding assets in the four countries of operation. "While these countries have many things in common, they are four different FX exposures, with economies in different cycles," says SBB chief executive Ilija Batljan.

SBB does not use hedging instruments but matches assets with financing in the same currency, termed natural hedging. "When we buy assets in Norwegian krone, then we do our debt financing in Norwegian krone; when we buy assets in euro, we do the same," says Mr Batljan.

POTENTIAL RISKS

While the euro has normalised, with a relatively long-term neutral position against the US dollar, more broadly there are signs of deceleration in the EU, says John Hardy, head of FX strategy at Copenhagen-based Saxo Bank. "And if a global trade confrontation erupts, the eurozone is poorly positioned as a large exporting bloc. Suddenly, some of the shine has come off of the euro," he adds.

Similarly, the stocky is vulnerable to global trade swings due to Sweden's export-based economy. "If global growth gets back on track then it may recover – but we aren't expecting inflation to come back in any notable way," says Mr Hardy.

The nokkie is better placed, with Norway's oil fund helping to power through the credit cycle. "But the economy has similar structural vulnerabilities as Sweden, such as a housing bubble of almost equal size relative to the economy," says Mr Hardy.

Notably, Norges Bank, the Norwegian central bank, has signalled an interest rate rise in September, ahead of the Riksbank and the ECB, which may help strengthen the currency. TB