Sweden real estate sets trend for Nordic hybrid issuance: investor scrutiny grows

Swedish real estate companies are increasingly active issuers of hybrid securities, one of the clearest signs of growing pressure from investors on Nordic companies to widen sources of funding while trying to preserve credit quality.

The trend is not unique to Sweden or the Nordic region, but the Swedish real estate sector provides a good snapshot of the forces shaping changing corporate approaches to funding in the aftermath of the global financial crisis and the Covid-19 shock. European companies in general are issuing growing amounts of conventional and hybrid bonds to add to the bank debt and common equity on which they have typically relied in the past - particularly given the importance of having ample liquidity during the Covid-19 crisis.

Our research shows that hybrid financing in the Nordic region is most prevalent in Sweden, both in terms of hybrid bonds, preferred stock and perpetual D-shares. For example, of the four Nordic economies, Sweden accounted for 62% of hybrid bonds issued since 2013.

Sweden also has the largest concentration of large property companies among the four countries, explaining why they have accounted 93% of hybrid-bond issuance in the same period. The capital-intensive nature of the real estate industry typically lends itself to long-term debt financing.

Whereas for decades Sweden's real estate companies were comfortable relying on bank debt, the changes in international and local banking regulations after the global financial crisis, which increased the capital requirements and pushed up the cost of bank lending to companies, has led corporate treasurers to turn more to capital markets for funding, as they have in many other European markets. The change in approach by the Swedish real estate sector has been dramatic, accounting for around SEK 160bn in outstanding bonds in 2019 compared with less than SEK 4bn in 2011.

More specific to the Nordic region is the push by institutional investors to ensure credit quality is maintained in the process of the diversification of investible securities.

The Norwegian Fund and Asset Management Association (VFF), which has a reputation for setting the tone for the rest of the region, has stepped up requirements for members to include only rated companies in investment portfolios, such as fixed-income funds. This puts pressure on non-financial issuers to obtain external credit assessments. In Sweden, the Riksbank – the central bank – started its own programme of buying corporate debt to provide monetary support for the economy and local capital markets in September this year. Non-financial corporate bonds eligible for the programme require minimum creditworthiness determined by ratings from at least one of five established credit rating agencies: Standard & Poor's, Moody's, Fitch Ratings, Nordic Credit Rating and Scope Ratings.

The cost of funding for depends increasingly on the credit rating that an issuer has, hence the importance of the weight of debt and equity on the balance sheet. In any assessment of corporate creditworthiness, the characteristics of preferred stock and hybrid bonds vary from issuer to issuer and need to be seen in the context of the entire capital structure of the company in question.

For preferred stock, a company's assessment of its equity content can vary from 0% to 100%, with the most likely outcome being 50%-100%, in our view. D-shares in most cases deserve to be classed as 100% equity.

Hybrid bonds, by definition, display mixed characteristics, and while the equity component can be weighted as much as 100%, typically, the weighting ranges from 0%-50% in our methodology.

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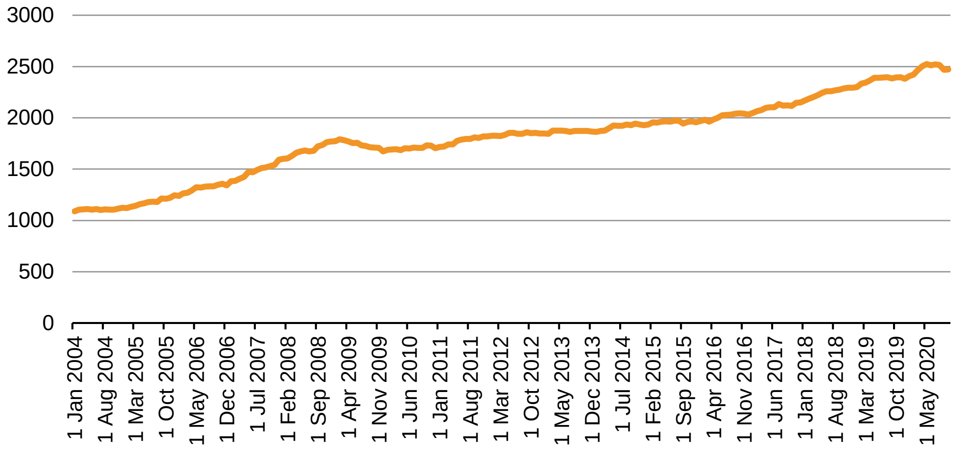
Changing Nordic capital structures: Swedish real estate case study

Sweden has largest Nordic real estate sector by market cap

The market capitalisation of the listed Nordic property companies currently stands at EUR 71bn. Swedish companies dominate the sector, accounting for 82% of the market value, followed by Finland (8%), Norway (7%) and Denmark (3%).

The ratio of debt to equity in Swedish real estate corporates has been relatively stable over time (2005-2017), with around 35% equity to 65% debt[1]. This contrast with companies outside the sector which show an inverse ratio. From 2005 until the financial crisis spilled over to Swedish real estate in late 2008, real estate companies recorded strong credit expansion in line with other non-financial companies (**Figure 2**), reflecting a bull market with readily available senior bank debt and fierce competition from 15-20 domestic/international banks.[2] A bear market followed in 2009-2010. Bank financing dried up, with between two and six domestic lenders hesitant to lend. Asset values stagnated or declined.

Figure 1: Bank lending to non-financial corporates Sweden



Source: Swedish statistical office, Scope

Tougher banking regulations play key role in Sweden

The evaporation of bank financing was the starting point of a change in real estate companies' financing structure. Corporate treasurers broadened their choice of funding to capital market debt, hybrids and preference shares. In the aftermath of the crisis, banking regulations also became stricter. Growth in capital-market funding in Sweden was closely tied to the stricter Basel 3 and local banking regulations which increased the capital requirements for banks and with it the cost of bank debt for corporate borrowers. Despite the regulations, bank lending has continued to grow, but at a more modest pace, with real estate firms accounting for 40% of bank lending to non-financial corporates in 2019[3]. The Swedish authorities again tightening banking regulation this year, imposing stricter capital requirements and higher risk weights for lending toward commercial and residential real estate, pushing up the cost of borrowing by an estimated 15-30bps[4]. The change, coinciding with the impact of the Covid-19 crisis, has contributed to the drop in bank lending we have witnessed in Sweden in 2020.

[1] Sweden's Riksbank financial stability report 2017/01

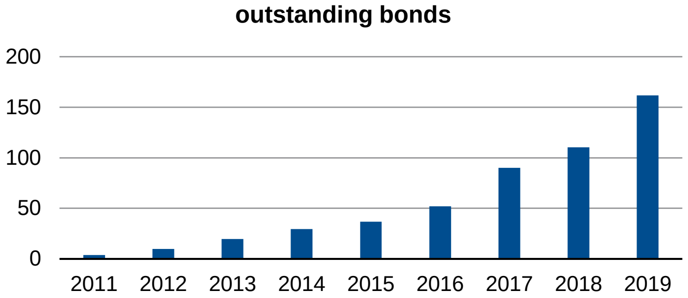
[2] Pangea Property Outlook 2018 - Sweden

[3] Sweden's Riksbank 'A new indicator of risks and vulnerabilities in the Swedish financial system' May 2020

[4] Pangea Property Outlook 2020 - Sweden

Figure 2:

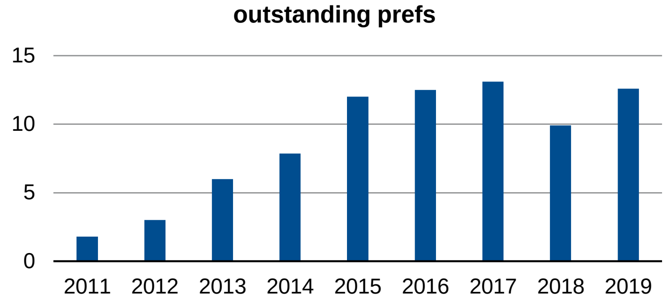
Outstanding bonds Swedish RE corporates (SEKbn)



Source: Thomson Reuters, Pangea Property, Scope

Figure 3:

Outstanding pref shares Swedish RE corporates (SEKbn)



Source: Thomson Reuters, Pangea Property, Scope

Surge in Swedish real estate company bond issuance 2011-19

The dramatic increase in the volume of real estate corporate bonds issued in Sweden to more than SEK 160bn in 2019 from less than SEK 4bn in 2011 demonstrates the shift in financing towards capital markets (**Figure 3**). The change equates to an increase from around 2% of total lending through bonds in 2011 to 27% in 2018.[5] This stellar rise was indirectly helped by the Riksbank's monetary policy, which pushed down long-term interest rates on treasury bonds and other low-risk interest-bearing investments (e.g. covered bonds). Investors turned their search for yield elsewhere. High demand from investors resulted in lowered credit risk premiums for commercial real estate companies, boosting certificates and bonds in relation to bank loans. In addition, the negative 3m Stibor which has prevailed since 2015 has been the reference when setting bond terms contrary to bank loans where lenders have set a floor at zero in their respective variable lending rates, further increasing the attractiveness of corporate bonds/certificates.

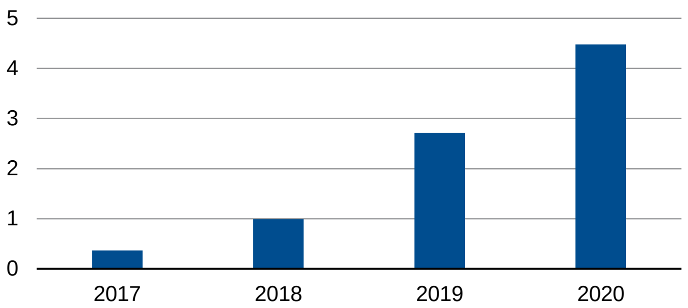
Preference shares fall out of favour

The preference share market developed in tandem with the bond market, at least up until 2015 when it started to flatten out (**Figure 4**). Initially intended as a substitution for share issues with limited dilution, the instrument fell out of favour when investors and credit rating agencies alike started to question the equity nature of preference shares. For a debt instrument, the cost of capital was far too high and real-estate firms started substituting preference shares by issuing bonds, hybrid bonds or the newly created D-shares. In the preference share market, the dominance of Swedish issuers in the Nordics is even more striking, with 57 of 63 issues in the past decade.

[5] Sweden's Finansinspektionen 'Commercial real estate market and its vulnerabilities' April 2019

Figure 4:

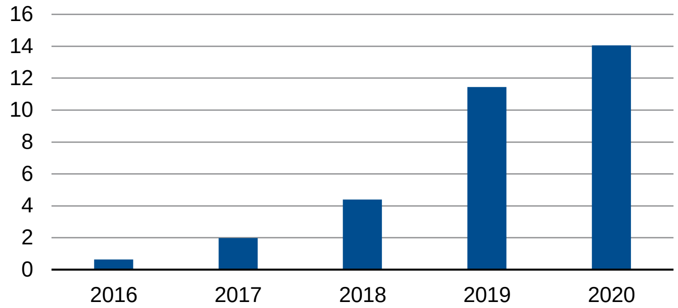
Outstanding hybrid bonds Swedish RE corporates (SEK bn)



Source: Bloomberg, Scope

Figure 5:

Outstanding D-shares of Swedish RE corporates (SEK bn)



Source: Company reports, Scope

Hybrid bonds replace preference shares

As preference share issuances stalled, Swedish real estate companies turned to hybrid bonds to broaden their capital structure (**Figure 4**). Most of those are perpetual by terms as are preference shares, but include call dates and step-ups that in practice give the issuer an incentive/possibility to retire them. In the Nordics, all but one of hybrid bonds issued by real estate companies were Swedish - Finland's Citycon Oyj.

D-shares increasingly in vogue

D-shares – a form of perpetual preferred stock without preference: dividends are linked to pay-outs on ordinary shares with an upper cap; 1/10 voting rights of common stock – were created to replace preference shares. We will come to their treatment from a credit rating perspective later, but the intention of investment bankers and issuers alike was to create an equity like instrument that provides a foreseeable cash-flow, with the pay-out of the maximum dividend the most likely outcome under normal business conditions. Sagax was one of the first companies to issue D-shares and has subsequently retired its preference shares.

We expect the market for alternative financing outside traditional bank debt to grow further, as i) senior unsecured bonds release previously pledged assets, ii) investors' search for yield benefit the creation of new hybrids of various aspects and terms and iii) new issuers enter the hybrid bond market and most existing issuers continue to use hybrid proceeds to refinance upcoming calls on existing outstanding similar hybrids to preserve the equity weighting granted by rating agencies.

Issuing hybrids: how do Swedish real estate balance sheets compare

Given the capital intensity of the real estate sector, companies face a challenge: how to balance shareholder's interests between the cost and dilution of issuing new equity with issuing new debt which increases leverage and can push financing costs higher. Hybrid instruments – including hybrid bonds, preference shares and D-shares - are generally favourably treated by IFRS accounting standards and auditors which do not include them in debt. The real test, however, is how lending banks and investors judge them, hence the pressure to find a third- party opinion which is where rating agencies come into play.

In **Figure 6** and **Figure 7** below, we give examples of how capital structures diverge as companies rely more on hybrid forms of funding. **Figure 6** shows illustrative examples of traditional and more complex balance sheets, while **Figure 7** shows the subtle differences in the capital structures of Swedish real estate companies as their funding choices have diverged.

Figure 6: Illustrative capital structures: company A relies on equity, bank debt/bonds; company B has diversified, relying partly on hybrid sources of funding

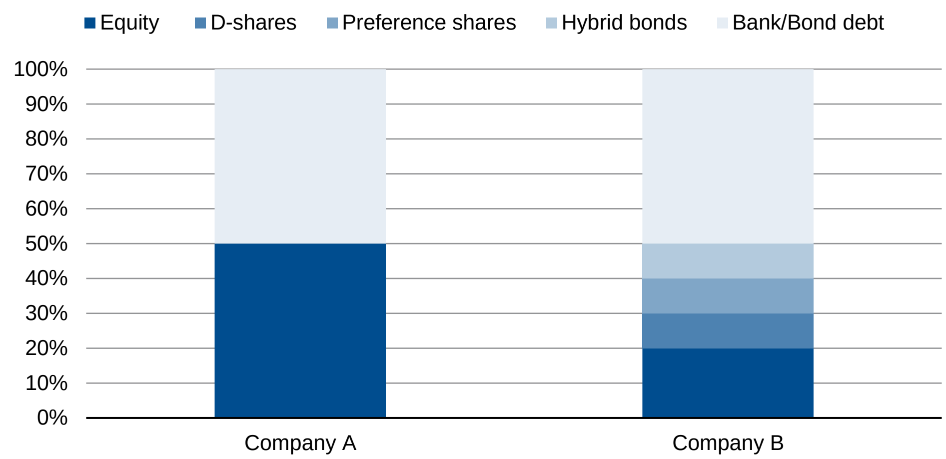
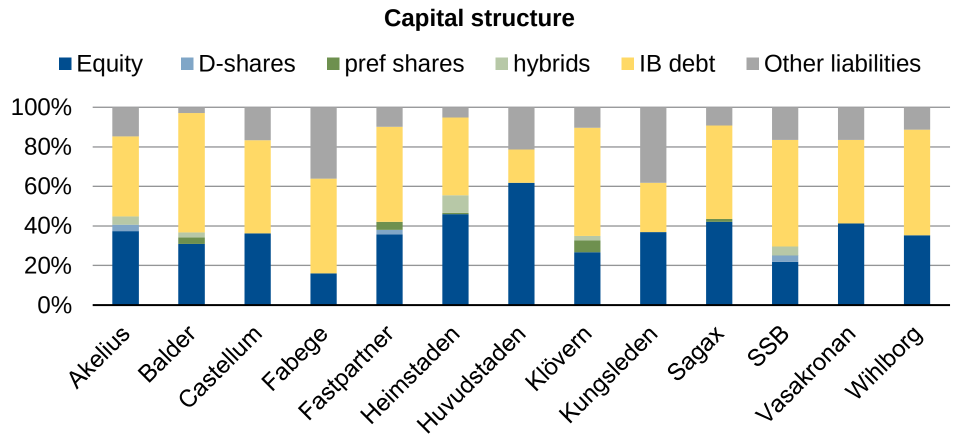


Figure 7: Swedish real estate companies' capital structures compared



Source: company reports, Scope

Hybrids can offer equity-like flexibility

As can be seen in **Figure 7**, a growing number of Swedish Real estate companies use hybrid securities. As market participants, we believe hybrid securities offers benefits for issuers and investors.

From an issuer's point of view, hybrid securities can provide an equity-like flexibility at a lower cost of capital which is less dilutive to equity, while there are normally fewer covenants and restrictions attached than for pure debt. In addition, the securities can open up new pockets of money by attracting investors beyond those interested only in traditional instruments, especially in a low interest-rate environment such as today's. If such instruments possess enough features to be warranted partial (or even 100%) equity content from a credit rating perspective, they do have the additional benefit of not burdening most of the company's credit ratios.

Better cash flow visibility is another hybrid plus

From an investor's perspective, hybrid securities can offer a potentially more foreseeable cash-flow stream than equity, a higher pick-up of yield than corporate debt given its subordinated nature or, in the case of preference shares, some voting rights (even though reduced compared with ordinary stock).

Scope Ratings' approach to rating hybrid securities

In discussions with issuers, investors, DCM and other market participants, we observe that instruments which fall in between the traditional A/B equity classes and senior unsecured bonds – or more senior paper – are viewed very differently. Some see preference shares as equity given the name, while others see them as debt given certain characteristics. Some regard hybrid bonds primarily as debt but others see them as essentially forms of equity – often for the same reasons.

Credit rating hinges on full assessment of capital structure

As part of our ratings work, we assess the company's capital structure in its entirety, starting from pure debt instruments like plain vanilla secured and unsecured debt, to what we as a rating agency call hybrids: subordinated debt with certain features, hybrid bonds with call dates, convertible bonds, preference shares, D-shares, etc to name a few relevant ones in the Nordics; and finally equity share classes (the latter is not assigned a credit rating).

Within its general corporate rating methodology, Scope has outlined some criteria under which circumstances the agency grants equity credit to such instruments. The main question a committee tries to answer for such instrument is twofold: i) how much equity characteristics does the instrument possess, assessed through its permanence in the capital structure and the absence of mandatory regular compensation; and ii) its contractual subordination to pure debt instruments.

Our criteria include five features that act as a guidance in our assessment. If most of the requirements are met in one of the two categories in the table (50% or 100% equity content), we apply the respective treatment (either 50% or 100%) – in absence of such fit, the instrument is treated as debt. If justified by important reasons, we may deviate from the scale based on analytical judgement.

Figure 2: Scope's equity credit criteria

Criteria	100%	50%
1. Convertibility	Conversion of hybrid bond into equity for the rated entity is mandatory	Issuer has the right to convert the hybrid bond
2. Replacement	Replacement with a similar debt instrument with equal maturity and rank (subordination) is mandatory	Replacement with a similar debt instrument with equal maturity and rank (subordination) is mandatory
3. Coupon deferral and cumulation of payments	Includes coupon deferral Non-cumulation of payments (issuer is not required to pay missed obligations at later periods)	Includes coupon deferral Cumulation of payments (issuer pays missed obligations at later periods)
4. Contractual subordination	Yes – all other current and future instruments rank before hybrid bond issue; hybrid bond ranks before equity	Yes – all other current and future instruments rank before hybrid bond issue; hybrid bond ranks before equity
5. Remaining maturity	More than 50 years or perpetual	More than 20 years

Source: Scope Ratings

Depending on the outcome of the rating committee on hybrids, Scope adjusts its credit metrics and ratios accordingly to reflect the 0%, 50% or 100% equity characteristics of such instruments in the capital structure.

Scope's methodology explained

Hybrid instruments

Convertibility

Convertibility is a decisive feature of hybrid bonds

Convertibility of a hybrid bond into equity is a mandatory feature for 100% equity credit under convertibility, while the issuers right to convert the bond grants a 50% treatment, if further requirements and features of the instrument, as laid out in our equity credit criteria are met.

This feature applies mostly for traditional convertible bonds with a conversion feature built in. In our observed sample (all hybrids issues in Sweden by Real Estate companies, source Bloomberg) we have only found one mandatory conversion convertible (from SBB i Norden). The Nordic preference shares and D-shares observed mostly possess a 1/10 voting right of an A/B share and can therefore be seen as closer to equity than a convertible bond in that perspective.

Replacement

Subordination crucial for equity credit

Replacement with a similar debt instrument with equal maturity and rank (subordination) is perceived as mandatory for both 50% and 100% equity credit. Reason behind this replacement requirement is the permanence characteristics within the capital structure that Scope would like to be reasonably assured of.

In Nordic (and often also European) documentation of hybrids, this feature is not specifically included, leaving the assessment to either historic evidence or analytical judgement based on discussions with the issuer. Scope would appreciate to see more committed documentation in terms of the replacement feature.

Coupon deferral and cumulation of payments

In order to qualify for equity content, a hybrid needs to possess a coupon deferral optionality to distance itself from traditional debt. To qualify for 50% equity content a cumulation of payments at later periods is allowed, to qualify for 100% a non-cumulation is demanded.

Cumulation optionality upon deferral weakens equity component

D-shares receive dividends in a similar way that A/B shares do and if those are cancelled, so is the D-share's pay-out. Preference shares do possess deferral options with cumulation/non-cumulation features to be assessed, while other hybrids may or may-not have the potential to defer without causing implications. A deferral optionality with strings attached – e.g. penalty interest or dividend restrictions – incentivise a timely pay-out and therefore weaken the equity content assessment.

On a sidenote: In case preference share documentations have built-in restrictions on the pay-outs of common shareholders/D-shareholders, we assess the likelihood of such preference share dividend pay-outs as given in the course of normal business and therefore adjust free-operating cashflows by these pay-outs.

Contractual subordination regarding hybrid securities

Hybrid instruments act as loss-absorbing buffers

Contractual subordination to all current and future traditional debt instruments is a mandatory feature for both 50% and 100% equity content (ranked only ahead of equity). As such, these hybrid instruments act as a loss-absorbing buffer to more senior debt classes, which can be beneficial for the issuances of non-IG issuers in a recovery analysis.

Most hybrid bonds are typically subordinated to traditional senior and subordinated debt in the capital structure and therefore fulfil these criteria. Preference shares typically rank below hybrid bonds, followed by D-shares which are just above common equity.

Remaining maturity

Permanence important aspect of equity content

To qualify for equity content, Scope needs to be reasonably sure of the permanence characteristics of a hybrid instrument and has therefore set a remaining maturity of more than 20 years for 50% content; and more than 50 years or perpetual to qualify for 100% equity content.

While certain hybrid bonds do possess very long maturities (up to perpetual), they also feature call-options and step-ups that incentivises the company to call/redeem, which can dilute the permanence characteristics implied by its long maturity.

Perpetual characteristics of preference shares

Preference shares are mostly perpetual and do not have the call/step-up features of hybrids, but most do possess the feature of a redemption price at which the company could repurchase its outstanding shares, acting somewhat as a ceiling for market prices. And some few do carry a reduction of such redemption price at a set future date, increasing the incentive of a company to redeem and with it diluting the permanence of the instrument.

The observed D-shares in the Swedish market are perpetual by nature and free of redemption incentives, i.e. reasonably assuring us of the permanence in the capital structure.

Summary of our treatment of hybrid securities

Fastpartner, Klövern ratings illustrate Scope's approach

D-shares in most cases can be considered to have 100% equity content.

Preference shares favoured by corporate issuers in the Nordics have mixed characteristics. Depending on their specific features and in a holistic assessment of the company's capital structure, the company's assessment of its equity content can vary from 0% to 100%, with the most likely outcome being 50%-100% equity weighting.

Hybrid bonds also have mixed characteristics. We take a company's entire capital structure into consideration. While equity content can range from 0%-100%, the most likely outcome is lower than for preference shares in the range of 0%-50%.

For example, Swedish real estate companies Fastpartner AB (BBB-/Stable) and Klövern AB (BBB-/Stable), both rated by Scope, have issued hybrid instruments. Both companies have preference shares outstanding which were granted 100% equity content based on their respective features. Fastpartner has D-shares outstanding which were granted 100% equity content; Klövern has hybrid bonds outstanding, which were granted 50% equity content under our methodology.

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