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Fitch Revises Heimstaden Bostad AB's Outlook to Negative; Affirms IDR at 'BBB'

Fitch Ratings - Stockholm - 26 Sep 2022: Fitch Ratings has revised Heimstaden Bostad AB's Outlook to Negative from Stable, while affirming its Long-Term Issuer Default Rating (IDR) at 'BBB'. A full list of ratings is detailed below.

The Negative Outlook reflects slower-than-expected deleveraging, driven by the recent high pace of investments, which has reduced the ability to deleverage using operational cash flow at a time of rising interest rates. In 2022 management have actively reduced leverage by raising new equity both in the parent company and through its JV with Allianz. Nevertheless, Fitch forecasts net debt/EBITDA to be above 25x at end-2022 (2024: 23x). Furthermore, Fitch forecasts that rising interest rates will gradually reduce interest cover (Fitch includes 100% of hybrid interest) towards 1.5x in 2024 from an estimated 2x in 2022.

The affirmation reflects Heimstaden Bostad's position as one of the largest residential landlords in Europe, benefitting from wide diversification across several countries in northern and central Europe. The local property markets exhibit positive demographic trends and disposable income growth, low vacancy rates, and a mix of market and regulated (below market) rents. These positive traits provide a stable rental income profile.

Key Rating Drivers

Higher-than-Expected Leverage: Fitch forecasts deleveraging to below 22x net debt/EBITDA to take longer than initially expected, driven by continued investments in Heimstaden Bostad's property portfolio via acquisitions and developments, the acquisition of Heimstaden AB's country management activities and financial investments (Kojamo Oyj). This, combined with rising interest costs, has decreased the ability to deleverage through operational cash flows. Heimstaden Bostad has various mechanisms to strengthen its balance sheet, as it has proven in the past, but this has not been included in our rating case.

Inflation Testing Operational Model: The current inflationary environment will put pressure on residential regulatory regimes and its often indexed-linked rental growth, and on tenants' affordability of market rents. Overall, we expect inflation to increase Heimstaden Bostad's rental growth, but see profit margin pressures in some countries in the short term, as rental growth indexation may be smoothed over more than one year, while cost increases (especially energy-related) are front-loaded. For market-rent markets, the strength of tenants' disposable income will determine how large rental increases tenants can absorb. Fitch expects Heimstaden Bostad to benefit from its diversification across countries and regulatory regimes.

Acquired Country Management Organisation: During 3Q22, Heimstaden Bostad acquired the country management organisation with 2,000 employees for SEK3 billion from its parent company Heimstaden AB in an arms' length transaction, thereby simplifying its organisational structure and improving its operating margin. Management estimates SEK130 million in annual operational cost savings. Practically, property management operations continue as before. The portfolio management agreement with Heimstaden AB was also extended to 2047.

Equity-funded Hybrid Buyback: Heimstaden Bostad repurchased during 3Q22 part of its hybrid bonds with a nominal value of EUR868 million with EUR649 million (SEK6,885 million) equity funding from existing institutional investors. The bonds were acquired at a discount to their nominal value based on current market pricing. The repurchase has strengthened Heimstaden Bostad's balance sheet as the hybrid bonds (Fitch applied 50% equity credit) were replaced by equity.

Sizeable Residential Portfolio: Heimstaden Bostad has expanded its large property portfolio further to SEK336 billion at end-2Q22 (approx. EUR32 billion). The residential-for-rent portfolio is Nordic-focussed, with additional diversification from properties in Netherlands, Germany, UK and CEE countries. This provides wide diversification across countries and cities, and reduces exposure to individual regulatory regimes, economic, and demographic trends.

Regulated and Market Rents: Demand for Heimstaden Bostad's residential units are supported by necessity-based demand, structural undersupply, and resultant low vacancy. The stability of its rental income is further supported by the group's mix of regulated (60% of rental income) and market rents (40%). Historically, Heimstaden Bostad has achieved like-for-like rental growth and vacancy below 5%. Management has targeted markets where home ownership is already established, and therefore government measures to preserve households' wealth creation are in line with conducive conditions for the rented residential portfolio.

Unique Governance Framework: Fitch rates Heimstaden Bostad on a standalone basis based on its unique governance framework. Heimstaden Bostad has grown its portfolio by attracting capital from large Nordic institutional investors and by dividend reinvestment. The relationship between the owners is governed by a shareholder agreement, which gives the institutional owners control over key strategic matters (defined as reserved matters) while day-to-day operations are handled by the majority owner Heimstaden AB, which also has the majority of shareholders' votes.

Reserved Matters: The shareholder agreement ensures the concentrated ownership does not adversely affect governance and makes Heimstaden Bostad more akin to a public company. Board and owner decisions on reserved matters require varying institutional shareholder majority thresholds of institutional votes, depending on the strategic importance, or board approval with maximum one vote against for certain issues. Reserved matters include, but are not restricted to, changes to financial policy, business plan, dividend policy and making larger divestments.

Profit Reinvestment: Profits are divided among the owners through different proportions of stapled ordinary and preference shares. This ensures majority voting for Heimstaden AB while institutions receive some preference in profit distribution.

Good performance is rewarded via Heimstaden AB's higher proportion of ordinary shares, which are remunerated from profits after the preferred shares have been paid. The owners in Heimstaden Bostad are obliged, in certain instances, to reinvest all or part of their preference distribution through a (ordinary and preference) share-rebalancing mechanism. Historically, the owners have reinvested a large part of their share distribution.

Derivation Summary

With its enlarged portfolio of EUR32 billion, Heimstaden Bostad is the second-largest European residential landlord, with around 153,000 units in the Nordics, central Europe, UK and CEE (Czech and Poland) providing wide diversification. Its combined portfolio value is larger than Fitch-rated Annington Limited's (BBB/Stable; EUR9.8 billion) Ministry of Defence housing portfolio, and materially larger than Grainger plc's (BBB-/Stable; EUR3.4 billion) residential-for-rent portfolio. Both Annington and Grainger are located across the UK. It is also larger than Peach Property Group AG's (BB/Stable; EUR2.6 billion as at December 2021), located mainly in the North Rhine-Westphalia region of Germany.

In all cases, Fitch acknowledges the necessity-based purpose of and demand for this asset class, the stability of rental income in many markets (particularly the regulated-rent markets), the fundamentals of inherent demand as household numbers increase and the lack of supply in many markets.

Longevity of tenant stay is conducive to stable income, as seen in many entities' occupancy rates and rent collection even during the pandemic, and rental uplift is planned for post-refurbishment units. Different companies have different policies of concentrating on city centres or more urban locations. Various forms of tenant-protective rental regulation, constraining rental growth, are in place per country.

Compared with commercial real estate, the net initial yields (NIYs) on residential-for-rent have been lower, reflecting the above underlying qualities and the different interest-rate regimes of countries. Fitch acknowledges the higher debt capacity of residential-for-rent assets compared with more volatile commercial real estate (office, retail, industrial) and adjusts all rated companies' net debt/recurring rental-derived EBITDA thresholds for their NIYs and the quality of each entity's portfolio.

Heimstaden Bostad's debt capacity, as measured by net debt/EBITDA (as seen in the upgrade and downgrade rating sensitivities), is similar to Akelius's (before its disposal took place). However, Akelius had similar yields but a wider geographic diversification as it benefits from a US and Canada portfolio. Compared with EMEA peers, Heimstaden Bostad's and Akelius's properties have lower average income yields of around 2.5%, reflecting their higher share of regulated rents than Grainger's UK portfolio and their locations in more attractive prime cities in comparison to Peach's secondary cities in Germany. The NIY on Grainger's regulated (and inherently shrinking) and growing market-rent portfolio is 2% and 4%, respectively, which corresponds to a blended 3% yield. Peach's average NIY is around 3.5%.

The geographical diversification of Heimstaden Bostad 's portfolio, which balances out city-specific developments such as Berlin rent regulation, stands out as a material benefit to their ratings compared with peers'.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer:-

- For net debt/EBITDA calculation purposes in forecast years, Fitch has annualised rents of signed and planned acquisitions, disposals and developments rather than include part-year contributions, which can affect this ratio
- Moderate 3%-4.5% like-for-like rental growth driven by annual regular uplifts, indexation and re-letting upon tenants vacating apartments
- On average SEK7.4 billion of capex per year, comprising developments and apartment upgrades. Fitch assumes an average 7.5% rental yield (increased rent) on this capex
- Continued portfolio growth through acquisitions, with around SEK12 billion of properties assumed to be acquired during 2022-2025
- Rising interest costs as debt mature and is refinanced and as derivatives expire

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Net debt/EBITDA below 19x
- EBITDA net interest cover above 2.5x
- Unencumbered investment property assets/unsecured debt above 2.0x
- For Fitch's EMEA REITs' senior unsecured debt uplift: a lower share of secured debt with maintained share of assets in liquid markets

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Net debt/EBITDA above 22x
- EBITDA net interest cover below 1.75x
- Unencumbered investment property assets/unsecured debt below 2.0x
- Changes to the governance structure that loosen the ring-fencing around Heimstaden Bostad

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three

years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

Liquidity and Debt Structure

Comfortable Liquidity: As at end-2Q22, Heimstaden Bostad had SEK6.7 billion in readily available cash in addition to SEK24.7 billion in undrawn revolving credit facilities, which comfortably covered SEK3.8 billion short-term debt maturities in 2022 and SEK10 billion other debt maturities in 2023. During 3Q22, Heimstaden Bostad repurchased hybrid bonds with a nominal value of EUR868 million at a discount, funded by newly issued equity. The group's average debt maturity was a long 9.1 years while its average interest rate was 1.1%, excluding the hybrid bonds.

Secured and Unsecured Debt Mix: Heimstaden Bostad is funded by a mix of unsecured (bonds and commercial paper), secured (traditional bank and Danish realkredit mortgages) and subordinated hybrid debt. At end-2Q22, 37% of debt was secured, 46% unsecured and the remaining 17% hybrid bonds. Its secured debt is primarily related to assets in Denmark, Netherlands, Germany and Sweden.

Hybrids Notched off IDR: Heimstaden Bostad's hybrid bonds are rated two notches below its IDR. The ratings reflect the hybrids' deeply subordinated status to senior creditors, with coupon payments deferrable at the discretion of the issuer and long maturity dates. The notching of the hybrids reflects their greater loss severity than senior obligations'. The securities qualify for 50% equity credit in accordance with Fitch's hybrid criteria.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Fitch Ratings Analysts

Fredric Liljestrand

Senior Director

Primary Rating Analyst

+46 85051 7809

Fitch Ratings Ireland Nordic Region Filial Kungsgatan 8 Stockholm 111 43

John Hatton

Managing Director

Secondary Rating Analyst
+44 20 3530 1061

Renee Lam
Senior Director
Committee Chairperson
+44 20 3530 1346

Media Contacts

Tahmina Pinnington-Mannan
London
+44 20 3530 1128
tahmina.pinnington-mannan@thefitchgroup.com

Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Heimstaden Bostad AB	LT IDR	BBB 	Affirmed	BBB 
• senior unsecured	LT	BBB	Affirmed	BBB
• subordinated	LT	BB+	Affirmed	BB+
Heimstaden Bostad Treasury B.V.				
• senior unsecured	LT	BBB	Affirmed	BBB

RATINGS KEY OUTLOOK WATCH

POSITIVE



RATINGS KEY OUTLOOK WATCH

NEGATIVE	⊖	◊
EVOLVING	◊	◆
STABLE	○	

Applicable Criteria

[Corporate Hybrids Treatment and Notching Criteria \(pub.12 Nov 2020\)](#)

[Corporate Rating Criteria \(pub.15 Oct 2021\) \(including rating assumption sensitivity\)](#)

[Corporates Recovery Ratings and Instrument Ratings Criteria \(pub.09 Apr 2021\) \(including rating assumption sensitivity\)](#)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 [\(1\)](#)

Additional Disclosures

[Solicitation Status](#)

Endorsement Status

Heimstaden Bostad AB EU Issued, UK Endorsed

Heimstaden Bostad Treasury B.V. EU Issued, UK Endorsed

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