Klövern AB
Sweden, Real Estate

SCOPE BBB- STABLE

Corporate profile

Klövern is one of the largest commercial property companies in Sweden, focusing predominantly on office space, with some minor exposure to retail (mixed-use office buildings to increase attractiveness) and logistics. The company owns and manages around 350 properties. In 2019, it sold most of its non-core assets to focus on good locations in large cities while improving financial figures. Klövern's strategy, besides a traditional buy-and-hold portfolio, is the acquisition of properties with sub-par occupancy and develop these through refurbishing and filling capacity.

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA/interest cover (x)	3.3x	2.5x	2.0x	2.2x
Scope-adjusted debt (SaD)/EBITDA (x)	16.7x	14.8x	18.4x	17.9x
Loan/value ratio (%)	61%	55%	54%	54%

Rating rationale

Scope assigns a first-time rating of BBB-/Stable to Klövern AB

The rating is supported by the company's good access to capital and investment markets as well as moderate diversification by geographies, with predominant exposures to major Swedish metropolitan areas, Copenhagen and New York. Moderate tenant diversification with a broad tenant industry diversification benefits the credit. Asset quality benefits from a high exposure to 'A' and 'B' locations after the portfolio streamlining in 2019.

The rating is constrained by comparatively low profitability, explained by the acquisition strategy, and by the relatively short weighted average unexpired lease term (WAULT) of 3.6 years, which creates an ongoing exposure to re-letting risks, compounded by Covid-19. Leverage as measured by the loan/value (LTV) ratio has recently improved and is expected to do so further, but the current level of 54% is constraining the rating.

Outlook and rating-change drivers

The Outlook for Klövern is Stable and incorporates a continuation of the company's growth in its core markets of Sweden, Copenhagen and New York, with capital expenditures and acquisitions amounting to SEK 3.3bn in 2020 and SEK 2.7bn in 2021. We expect the negative financial effects of Covid-19, built into our base case, to fade during 2021, with rents returning to pre-crisis levels in 2022. Scope-adjusted LTV (currently 54%, accounting for a 50% equity credit on its hybrid bond) is also expected to improve, while a recovery in EBITDA will benefit debt interest coverage.

A negative rating action is possible if LTV increases towards 60% on a sustained basis. This could be driven by an increase in interest-bearing debt through highly debt-financed acquisitions or re-mortgaging, or by a more severe Covid-19 effect leading to a stronger-than-expected revision of rental prospects and, in turn, lower asset values.

A positive rating action could be warranted by deleveraging, with an LTV of below 50% on a sustained basis, supported by break-even free operating cash flow. This could be driven by less debt-funded capex, a positive development of current ongoing development projects and a less severe impact of Covid-19 resulting in fair value appreciation.

Ratings & Outlook

Corporate ratings	BBB-/Stable
Short-term rating	
Senior unsecured rating	

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Real Estate Corporates January 2020

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Bloomberg: SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Medium-sized commercial real estate company with good access to capital markets • Moderate geographical diversification with a home bias in Sweden (40% Stockholm) in addition to Copenhagen and New York • Moderate tenant diversification with top 10 accounting for 19% of 2019 rental income; broad tenant industry diversification, with manageable exposure to industries hit hard by Covid-19 • Property locations in large metropolitan areas affording good liquidity • Solid debt protection levels	• Top three tenants relatively concentrated, with Ericsson accounting for 7.6% of 2019 rental income • Relatively short WAULT (though in line with Swedish market), exposing the company to ongoing re-letting risk • Relatively high vacancy, explained by company's acquisition strategy, somewhat mitigated by stability • Low profitability (60-65%) relative to peers due to capital-intensive development strategy • High leverage (LTV) for the rating, mitigated by recent portfolio streamlining that resulted in a lower LTV

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted LTV to decrease below 50% on a sustained basis	• Scope-adjusted LTV to increase towards 60% on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
Scope-adjusted EBITDA/interest cover (x)	3.3x	2.5x	2.0x	2.2x
Scope-adjusted debt/Scope-adjusted EBITDA (x)	16.7x	14.8x	18.4x	17.9x
Scope-adjusted loan/value ratio	61%	55%	54%	54%
Scope-adjusted EBITDA in SEK m	2018	2019	2020F	2021F
EBITDA	1,985	2,140	1,790	1,966
Operating lease payments in respective year	53	0	0	0
Other	0	0	0	0
Scope-adjusted EBITDA	2,038	2,140	1,790	1,966
Scope-adjusted funds from operations in SEK m	2018	2019	2020F	2021F
EBITDA	2,038	2,140	1,790	1,966
less: (net) cash interest as per cash flow statement	-615	-823	-852	-823
less: cash tax paid as per cash flow statement	0	-3	-44	-4
Less: interest component, operating leases	-6	-4	0	0
Other	6	14	0	0
Scope-adjusted funds from operations	1,422	1,324	894	1,051
Scope-adjusted debt in SEK m	2018	2019	2020F	2021F
Reported gross financial debt	33,688	31,515	32,503	34,547
less: cash and cash equivalents	576	449	265	140
add: derivatives	85	65	65	65
add: Hybrid bond (debt portion)	631	631	631	631
add: pension adjustment	0	0	0	0
add: operating lease obligations	157	0	0	0
Scope-adjusted debt	33,985	31,762	32,933	35,102

Business risk profile: BBB

Industry risk: BB

Industry risk for Klövern is modest, with an exposure to the highly cyclical commercial real estate industry (with its main segments comprising the development, leasing and management of office buildings).

Credit outlook stable for 2020

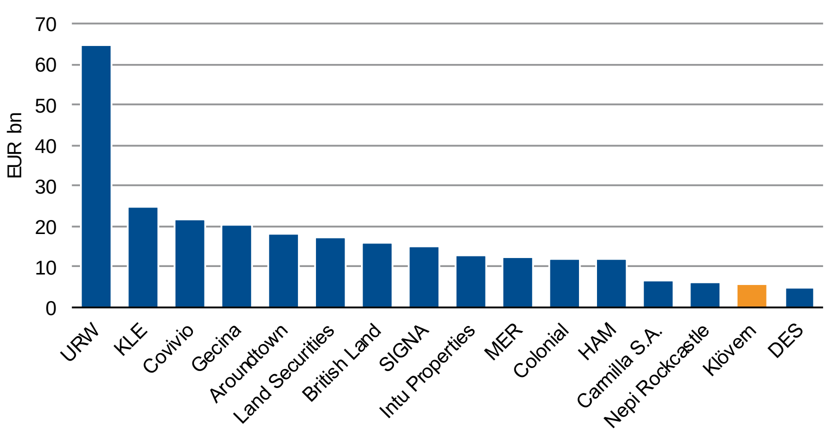
Real estate companies face an evenly balanced set of risks in 2020. This outlook factors some pressure in property prices as a result of: i) stable interest rates; ii) some easing of the supply-demand imbalance for most asset classes as development activity has picked up; iii) a further slowdown in economic growth, also as a consequence of the Covid-19 crisis; and iv) the uncertain development of international trade relations. We expect the impact of Covid-19 on the prime office market to be limited.

For more information, refer to the corporate outlook for real estate (click here).

Good access to capital markets driven by its size

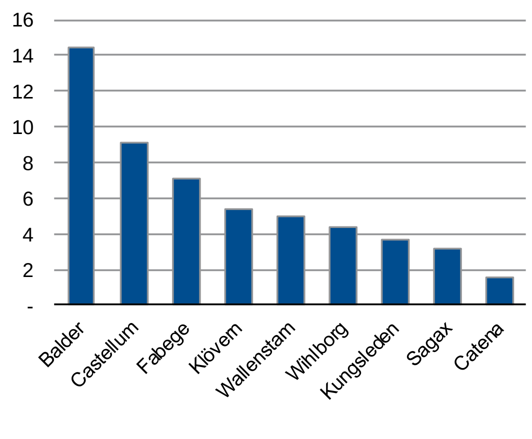
Klövern is a medium-sized commercial real estate company based in Sweden, with total assets of SEK 60bn (EUR 5.8bn) and a lettable area of 2,549,000 sqm. The company's size translates into decent diversification in terms of tenants and locations, which should enhance its resilience to cash flow volatility caused by economic cycles, industry developments, regulatory changes or the loss/default of single tenants. It also affords good access to capital markets, proven by the regular issuance of secured and unsecured bonds in Sweden, a SEK 4bn commercial paper programme, and bank loans/private placements with all significant Nordic banks denominated in either Swedish, Danish or US currency.

Figure 1: European peers, assets under management (AUM) in EUR bn



Source: Company accounts, Scope estimates

Figure 2: Swedish peers, AUM in EUR bn



Source: Company accounts, Scope estimates

One of the largest Swedish CREs, with a moderate or dominant market share

In Sweden, Klövern ranks mostly first or second in regional capitals and within the top 10 in Stockholm and Gothenburg. The moderate or dominant position in most areas and the high market share in the Swedish capital city are credit-positive, often providing higher visibility to potential new tenants and more opportunities to adapt to the changing needs of existing ones. Thus, the high market shares increase tenant retention and yield a more stable occupancy in addition to reducing capex needs linked to tenant fluctuations.

The company intends to increase market shares further in its home markets of Stockholm and Gothenburg, as well as in Copenhagen and New York. In 2019, Klövern disposed of most of its non-core assets located in towns to concentrate on large liquid markets in A locations.

Moderate geographical diversification across three countries, with a home bias

Klövern's geographical outreach is moderate, with a strong foothold across Sweden (85% of assets by fair value) and two international exposures with Copenhagen (7%) and New York (8%). Most of Klövern's performance thus hinges on the macroeconomic developments in Sweden and Denmark, two mature and stable economies with strong welfare/social systems. This softens the impact of economic shocks (as currently witnessed), which in turn reduces rental losses. The company intends to increase its share of international assets while strengthening its foothold in major cities, targeting a portfolio share of 40% in Stockholm and approx. 10% each for Copenhagen, Gothenburg and New York.

Moderate tenant diversification with good tenant industry spread

Klövern's tenant diversification is assessed as moderate, with the top three accounting for 11% and the top 10 for 19%. The concentration among the top three is due to Ericsson, which accounts for 7.6% of total rent. Klövern's top 20 tenants are investment grade, seven of which are government agencies/companies (AA-AAA), with three sub-investment-grade exceptions (two parking companies and a hotel group). Overall, 14% of rents stem from government agencies/companies, while the average credit quality of the company's roughly 4,200 tenants is low investment-grade based on the company's historical credit losses. As a result, we expect only a marginal risk of a significant deterioration in cash flows due to a single tenant's default or delayed payments.

Tenant industry diversification is good, with no dominant industries in the portfolio. The tenants most vulnerable to Covid-19 impacts (non-food retail, hotels, gyms, restaurants and office-hotels) account for 14% of total rent. Klövern's focus on mixed-use office buildings in inner-city locations somewhat mitigates the risk of significant vacancies within this basket, as potentially vacated locations provide a stream of potential customers (in offices) and are therefore sought after. Rents received from tenants have so far reduced by just 3% since the corresponding period in 2019, demonstrating the resilience of its tenants to Covid-19.

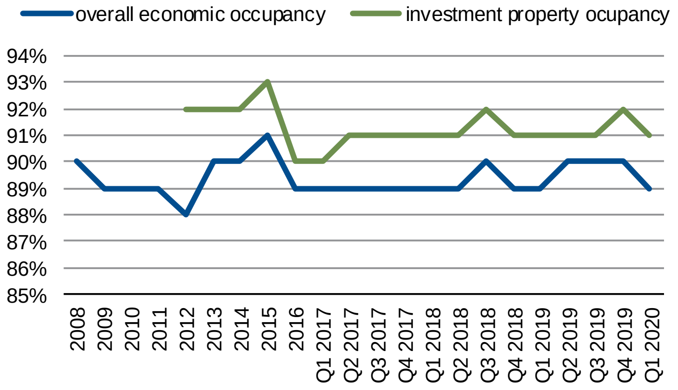
Asset quality benefits from 'A' locations

Klövern's asset quality benefits from the large share in its property portfolio of 'A' cities according to Scope's methodology. During 2019, Klövern streamlined its portfolio, disposing of non-core 'B' and 'C' locations and concentrating on 10 cities within Sweden. Metropolitan regions with more than 1m inhabitants now account for 74% of the portfolio. The portfolio has been streamlined around modern offices, through divestments of warehouse and logistics premises. The high share in large liquid markets is likely to result in good fungibility should the company fall under financial distress, meaning any haircuts on its portfolio would be limited – though a scenario of financial distress is remote given Klövern's decent financial risk profile.

Strategically chosen above-peer-average vacancy, mitigated by stability

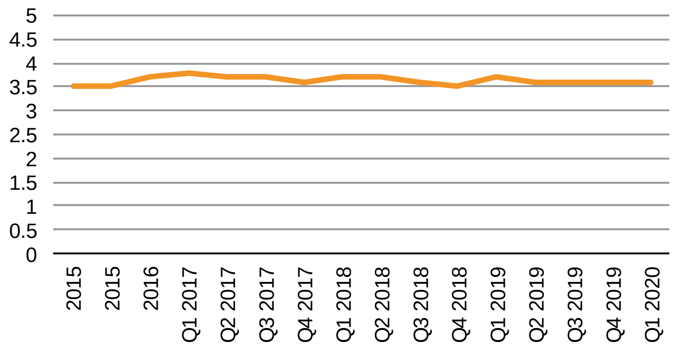
One of Klövern's strategic property management goals is an economic occupancy rate of at least 90%, with an optimal vacancy rate through the cycle of 8-12% across the portfolio (including development). Klövern's preferred acquisitions are properties in inner-city/near-city locations with below-par occupancy with the potential for property development. While these vacancy levels are high compared to those of traditional buy-and-hold competitors, we acknowledge the logic behind Klövern's strategy. Credit-positive is the stability of the company's occupancy, which moves within a very narrow corridor.

Figure 3: Economic occupancy rate



Source: Klövern, Scope estimates

Figure 4: WAULT



Source: Klövern, Scope estimates

Relatively short but stable WAULT

Klövern's WAULT of 3.6 years is short and exposes the company to ongoing re-letting risk. Over the last five years, the company's WAULT has been remarkably stable, at between 3.5-4 years, mitigating the somewhat low reading. Management aims for rental contracts with a duration of 3-5 years to enable rent to be renegotiated regularly to reflect market conditions, tying well into the above-described strategy of developing properties.

Klövern's WAULT is in line with the Nordic market average, which is rather short at four years. The associated risks are mitigated by the average length of Klövern's tenancies, at 15 years, demonstrating the attractiveness of its properties and the loyalty of its tenants. Re-letting risk due to the short WAULT is manageable as long as the economy grows and tenant demand is healthy. However, in light of Covid-19, lease extensions and new contracts could be subject to reduced rent levels. We highlight the risk of changing demand for office space in the medium term following the Covid-19 pandemic, which might impact Klövern's asset quality.

Focus on sustainability increases attractiveness of portfolio and company's profitability

Klövern follows UN Global Sustainability Goals and is targeting pure renewable energy consumption, climate-neutrality by 2025, and a 50% reduction in energy consumption by 2030 (compared to 2018). Increased resource efficiency in terms of renovation and recycling are top priorities, with the company using environmental certification systems (Swedish Green Building Council's Miljöbyggnad Silver/Gold level or a corresponding level of BREEAM and LEED) for every new construction/refurbishment. These efforts on social and environmental aspects enhance not only the attractiveness of its portfolio but also its profitability as the improvements increase the net rent ratio (rent excluding service charges) by maintaining gross rental levels.

Stable profitability, but below peer levels

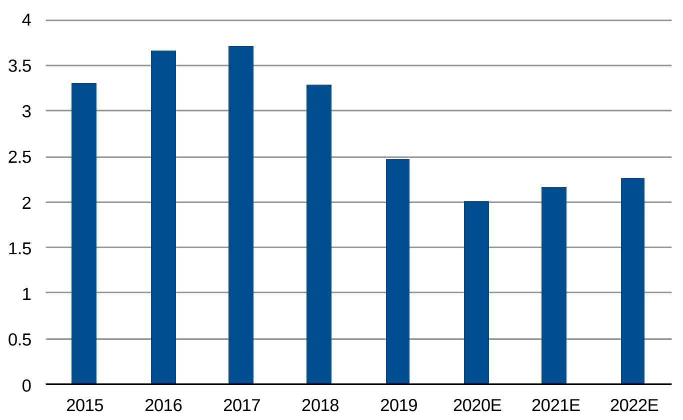
Klövern's profitability, as measured by the Scope-adjusted EBITDA margin, of 60-65% is at the lower end of its peer group, explained by its acquisition strategy focused on well-located properties with development potential, thus properties with higher non-recoverable service charges and higher investment/maintenance expenses. The stability of its profitability is somewhat mitigating the low reading.

Financial risk profile: BB+

Solid debt protection, expected to remain above 2.2x on a sustained basis

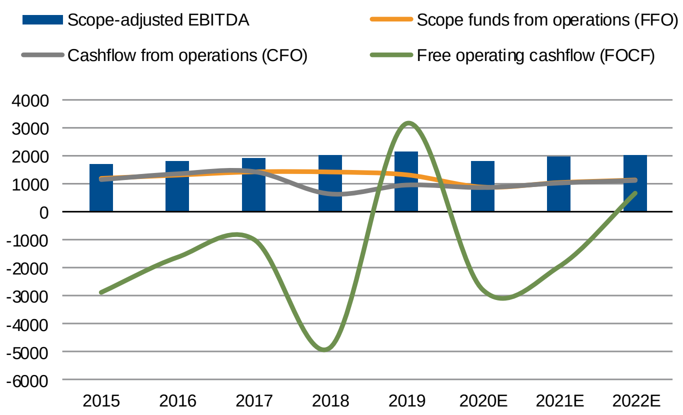
Debt protection is historically strong, at above 3x in 2018. Record low interest rates in combination with the company's preference for floating rates (of which at least 90% are hedged) has resulted in comparatively low cash interest payments. An increase in leverage in addition to hikes in rates have resulted in lower coverage since 2019, with debt protection expected to be sustained above our 2.2x rating threshold going forward (expected to dip below in 2020 due to Covid-19). Mitigating the risk of floating rates are i) the current economic environment, which will probably lead to another prolonged period of zero or negative interest rates; and ii) the company's hedging policy with currently 94% of floating rates subject to swaps (with interest rate caps at five-year government bond rates +3%). Klövern refinanced SEK 5bn of its debt in recent weeks at pre-Covid-19 interest rates (2.4% on average across all debt instruments), underlining its strong position in financial markets and giving comfort that interest coverage will not deteriorate significantly going forward. Another financial goal is keeping an interest coverage ratio of at least 2x at any time.

Figure 5: EBITDA interest coverage (x)



Source: Scope estimates

Figure 6: Cash flows



Source: Scope
'Sa' = Scope-adjusted

Operating cash flows grew in line with asset growth, taking a hit in 2020 due to Covid-19 impact

Scope-adjusted EBITDA has grown consistently, from SEK 1.7bn in 2015 to SEK 2.1bn in 2019, in line with the growing asset base. The company's funds from operations have increased in tandem with EBITDA, peaking in 2019. Going forward, we expect a Covid-19 impact in our rather conservative rating scenario, dragging down profitability and funds from operations, with a slow recovery in 2021 and 2022.

Free operating cash flow fluctuates with acquisition/disposal schedule; development capex covered by internal cash flows

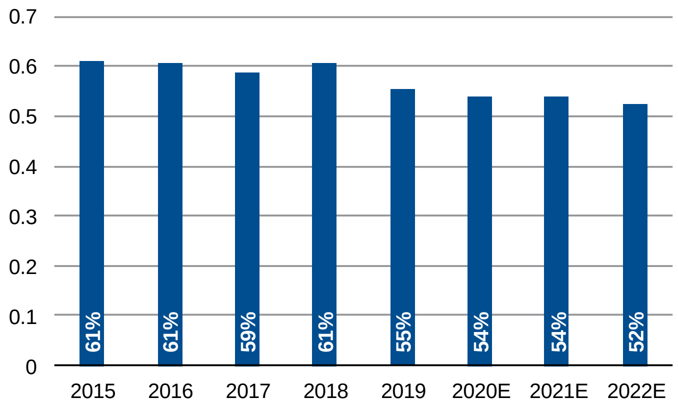
Scope-adjusted free operating cash flow is impacted by property acquisitions and disposals, with the significant asset growth in 2018 financed through external debt. In 2019, Klövern streamlined its portfolio and disposed of many assets in non-core locations, resulting in significantly positive cash flow. In the first quarter of 2020, the company again increased its asset base with four properties worth SEK 2.2bn and disposed of one non-core asset (SEK 258m). Combining this with investments in New York City developments as well as Covid-19 impacts, we expect free operating cash flow to be negative in 2020, with investments financed with external debt. Capex for development projects are expected to be covered by internal cash flows in 2021 and 2022; any additional planned acquisitions will be financed through either share/preference share issues, external debt, or a combination of both.

Klövern is not classified as real estate investment trust and therefore has no pressure to pay out most of its net income as dividends. The company has three share classes, each with different voting rights (including a preference share class assessed as equity by Scope), and intends to pay a long-term dividend at more than 50% of profits generated by property management. We understand that the company is willing to cut dividends based on how the current situation develops, providing a cushion on cash flows compared to our base case.

Decrease in loan/value benefits the rating

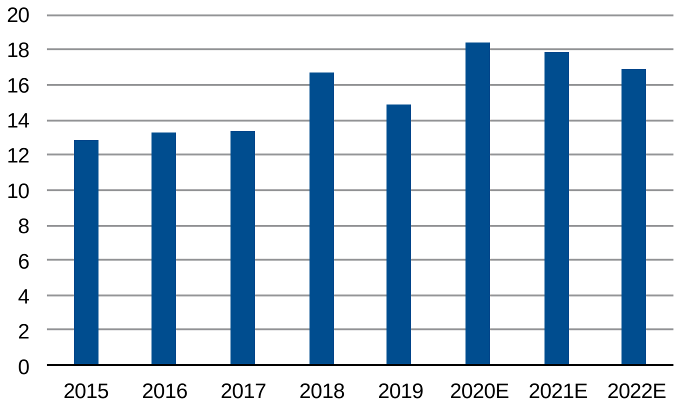
Klövern's leverage as measured by the Scope-adjusted LTV has reduced significantly due to portfolio streamlining during 2019, from the high 50s (%) to the mid-low 50s, levels the company intends to keep. We forecast LTV to decrease further in the coming years thanks to i) value-accreditive developments (e.g. in New York); and ii) our expectation of plateauing growth in interest-bearing debt as capex is covered by means other than debt. We expect a decrease in LTV, even with our cautious approach on fair value adjustments due to Covid-19.

Figure 7: Loan/value ratio (%)



Source: Scope estimates

Figure 8: Scope-adjusted debt/EBITDA (x)



Source: Scope estimates

Scope-adjusted debt to EBITDA has remained above 13x in the period analysed, and our rating case does not expect a significant reduction in this ratio going forward. The stark increase observed in 2018 is due to debt-financed acquisitions, including a hybrid bond issuance of SEK 1.3bn, of which 50% is considered equity under our methodology. Given that the company predominantly manages buy-and-hold properties, we do not apply a weight on this ratio.

Klövern has historically relied on short-term funding and kept a low cash balance. The company's strategy for short-term liquidity needs is to draw on revolving/cheque credit facilities or issue commercial paper under the SEK 4bn programme. In a second step, the company replaces short-term instruments with secured bank loans/bonds with a pledge in real estate. At year-end 2019, the company reported a secured LTV of 34%. This gives ample room to increase debt on existing properties, based on the usual framework of a maximum 60% LTV on bank loans in case the short-term market stops and prevents further refinancing. In addition, the company's revolving credit facilities cover the unsecured part of upcoming maturities; we consider the likelihood of banks not refinancing the company's secured loans to be low. The company enjoys good relationships with all major Nordic banks and has close ties through roughly 100 loans at various maturities.

Given the above, liquidity is judged to be adequate.

Position	2020E		2021E	
Unrestricted cash (t)	SEK	449m	SEK	140m
Open committed credit lines (t)	SEK	5.6bn	SEK	5.6bn
Free operating cash flow (t+1)[1]	SEK	-353m	SEK	663m
Short-term debt (t)	SEK	4.0bn	SEK	8.8bn
Coverage		**1.4x**		**0.7x**

[1] Excluding discretionary expansion capex

Appendix I : Peer comparison (as of last reporting date)

	Klövern AB	Inmobiliaria Colonial SOCIMI S.A..	Merlin Properties SOCIMI S.A.	WingHolding ZRT
	BBB-/Stable	--/--/--*	--/--/--*	B+/Stable/--
Last reporting date	31 December 2019	31 December 2019	31 December 2019	31 December 2019
Business risk profile				
Scope-adjusted total assets (EUR m)	6,014	12,285	13,051	1,500
Portfolio yield	5.4%	2.8%	4.0%	6.8%
Gross lettable area (thousand sq m)	2,549	1,614	3,304	505
No. of residential units	N/A	N/A	1.2	0.4
No. of countries active in	3	2	2	3
Top 3 tenants (%)	11%	9%	22%	34%
Top 10 tenants (%)	19%	24%	33%	44%
Office (share of net rental income or NRI)	73%	83%	46%	85%
Retail (share NRI)	13%	9%	24%	10%
Residential (share NRI)	0%	0%	0%	0 %
Hotel (share NRI)	3%	0%	0%	0%
Logistics (share NRI)	11%	5.%	10%	5%
Others (share NRI)	0%	3.%	19%	0%
Property location	A	A	A	B
EPRA occupancy rate (%)	90.0%	97.3%	94.8%	88.0%
WAULT (years)	3.6	4.0	5.6	5.7
Tenant sales growth (%)	N/A	N/A	N/A	N/A
Like-for-like rent growth (%)	N/A	4.0%	5.2%	N/A
Occupancy cost ratio (%)	N/A	N/A	N/A	N/A
Scope-adjusted EBITDA margin[2]	63%	79%	19%	37%
EPRA cost ratio (incl. vacancy)	N/A	20.4%	18%	N/A
EPRA cost ratio (excl. vacancy)	N/A	19.1%	N/A	N/A
Financial risk profile				
Scope-adjusted EBITDA interest cover (x)	2.5x	3.2x	3.7x	4.6x
Loan/value ratio (%)	55%	38%	41%	63%
Scope-adjusted debt/Scope-adjusted EBITDA (x)	14.8x	16.7x	13.2x	13.9x
Weighted average cost of debt (%)	2.3%	1.6%	2.1%	2.4%
Unencumbered asset ratio (%)	182%	289%	N/A	220%
Weighted average maturity (years)	4.1	4.9	6.4	na

* Subscription ratings available on ScopeOne

Sources: Public information, Scope

[2] includes all GLA surfaces, above and below ground

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