

Vasakronan's Q1 report: "Higher market yield requirements for commercial properties are very likely"

- Vasakronan posts a strong Q1, in line with listed peers
- A ~5% retail property value writedown
- Sees a high risk of higher yields on commercial properties

Vasakronan (not listed): Solid report with increased rental levels despite slowdown in retail
Yesterday (May 5), Vasakronan released its numbers for the first quarter of 2020. At the end of the quarter, the portfolio value amounted to SEK 155.5bn, up 11.5% y-o-y after solid growth throughout 2019. Rental revenue increased to SEK 1,764m in the quarter, which for comparable property holdings meant an increase of 4% y-o-y. Despite the negative property value change of SEK 1.8bn (1.1%) related to yield changes in the retail property segment, we find that the report looks like a solid start to the year, which was not a surprise following the market conditions in Q1 and solid Q1 reports from listed peers. The 1.1% value decrease is attributable to all geographic segments; however, on a weighted basis, the decrease is mainly attributable to Gothenburg (in absolute numbers, Gothenburg property values were down 2.6%, and down 2.7% in Uppsala). The writedown means a ~5% reduction on retail asset values (~20% of total assets), we understand. Vasakronan reported that renegotiated leases were up 10% in the quarter and that, of all the contracts renegotiated in the last twelve months, 67% (70%) decided to extend the contracts. Of the lease renegotiations for the last twelve months, just 1% (4.9%) relate to retail, implying continued headwinds in that property segment, albeit still in a positive territory. Just under 20% of Vasakronan's rental revenue is derived from the sectors initially most affected by the pandemic. Vasakronan says it has offered monthly payment of quarterly rents and a deferral of rent payments to the hardest-hit tenants. For the second quarter, Vasakronan has invoiced just over SEK 1,500m, of which about SEK 245m had not been received as of end-April. Agreements in the form of deferrals and monthly payments are in place for the majority of the sums outstanding.

Property value decreased by 1.1% in Q1 – all related to retail, it seems
Vasakronan's portfolio is tilted towards offices and retail premises in the central areas of Stockholm, Gothenburg, Malmö and Uppsala, and Q1 offered a slight q-o-q decline in the portfolio value with a negative value change of 1.1%, completely attributable to yield requirements across all geographic segments, but mainly driven by Gothenburg, and fully attributable to retail assets. On average, the yield requirement for the portfolio was 4.20%, compared with 4.16% for corresponding properties at the end of 2019. Uncertainty about the future and a shortage of financing has led to a halt in transaction activity. Therefore, the assumptions made in the valuation include an unusually high degree of uncertainty given that the long-term effects on property values are difficult to assess at present. As of March 31, 2020, the value decline in Vasakronan's retail properties was assessed at 5-10%. The scale of the decline depends on, among other things, the percentage of office space included in the respective retail property. At the end of the quarter, the value impact on office and public sector properties was assessed as limited.

Vasakronan states that the value of transactions in the Swedish property market increased SEK 6bn in the quarter, of which office property is the largest segment in terms of transaction volume, followed by residential property. The main portion of the volume is attributable to Stockholm. However, at the end of March, activity dropped owing to uncertainty about the future and shortage of financing. The office rental market remained strong in the first quarter in all of Vasakronan's geographies. Vacancy rates for office properties were unchanged. At the beginning of the year, yield requirements continued to fall before showing a slight uplift at the end of the quarter, as uncertainty surrounding the ongoing pandemic increased. For the retail properties, Vasakronan saw a slight decline in market rents and a minor increase in vacancies, which from March have been heavily affected by the COVID-19 outbreak. Vasakronan states that the effects of COVID-19 have been much more visible in the current quarter, with liquidity shortage, increased bankruptcies and reconstructions in several sectors. Looking ahead, higher market yield requirements for commercial properties are quite likely, according to Vasakronan.

Our thoughts on read-across and implications

We find that Vasakronan's report is in line with our view on Swedish real estate in general; Q1 numbers have been strong, as expected, and the market was functioning and supportive almost all the way up to the end of March. However, looking ahead, we stress that the fog is still very thick in terms of the repercussions from COVID-19, and we argue this uncertainty was demonstrated and confirmed by Vasakronan. We continue to believe that macroeconomic developments and the future state of capital markets will lead the way for both real estate in general and for the stock market sentiment. We now know that Q2 figures will be of worse character, although not very much, but the longer-term impact should be of greater importance and is still difficult to assess. Comments like "higher market yields for commercial properties are very likely" is not a positive, in our view, given that the sector is trading rather close to par on NAV valuation, and because several names are running on LTVs rather close to Moody's IG rating LTV hurdle (Castellum and Atrium Ljungberg). All else being equal, Vasakronan seemed to make a smaller writedown on retail assets (~5%) compared with Atrium Ljungberg (>10%), suggesting to us a cautious approach by Atrium Ljungberg. It could also imply that uncertainty is great and/or that different types of retail assets are facing different challenges, i.e. all retail properties are not expected to be impacted in the same way.

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On 2020-04-02 the recommendation Sell, which was set on 2019-03-08 at the share price of SEK 169, was changed to the current recommendation Hold at a share price of SEK 161.