FI Analysis No. 41

Commercial real estate firms may need to reduce their debt

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Summary

In this FI Analysis, we estimate how much Swedish listed and larger privately owned real estate firms need to reduce their debt to reach certain levels of interest coverage and loan-to-value. We have based our calculations on a scenario in which interest expenses continue to rise and property values fall. The commercial real estate firms' liabilities total approximately SEK 1,500 billion. Higher interest rates have increased the firms' financing costs. These, combined with a weaker economic outlook, have resulted in lower property values. This development increases the pressure on the interest coverage and loan-to-value ratios, both of which are important indicators for assessing the creditworthiness of real estate firms.

Though some firms have started to make debt adjustments, this analysis shows that more firms need to reduce their debt to deal with a scenario in which interest expenses rise to 5 per cent and property values fall by 20 per cent. In total, a debt reduction of about SEK 100 billion, or on average 15 per cent per firm, is needed for each firm to avoid an ICR below 1 and a loan-to-value ratio above 70 per cent. It is not necessary to reach these exact threshold values, but firms often strive toward better financial indicators that can be seen as more sustainable in the long term. This would further increase their need to reduce debt. Our assessment shows that a greater debt reduction is needed to maintain the ICR than to maintain the loan-to-value ratio.

Firms can strengthen their financial position in various ways and over time. The analysis indicates that some firms need to issue equity or sell properties. Compared to issuing equity, selling properties requires about twice the amount to reach the same results. Many firms may need to sell a large portion of their property portfolio or raise capital by other means. However, more than half of the total need pertains to just a few firms. In the worst case, this means that there are concentration and contagion risks that can lead to a self-reinforcing process.

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Commercial real estate firms strained by higher interest rates and large loan maturities

For a number of years, Finansinspektionen (FI) has warned of the risks that highly leveraged, interest rate-sensitive commercial real estate (CRE) firms pose to financial stability.[1] FI has also raised the capital requirements on banks' exposures to CRE firms.[2] For a long period of time, the sector has benefited from strong economic growth and low interest rates. Low interest rates made it profitable for CRE firms to borrow money to purchase and develop properties and thereby expand their business. This contributed to the sharp growth of the CRE firms' total debt. Bank loans make up a large portion of the debt, but the firms also have a great deal of market financing through bonds and certificates.[3]

In just over a year and a half, the Riksbank raised the policy rate from 0 to 4 per cent to cool the inflation. The Riksbank has also indicated that the policy rate will remain high for an extended period of time. In addition, banks have increased their loan margins and market credit spreads have risen. Rapidly rising interest rates greatly impact CRE firms as they have high debt, are very sensitive to changes in the interest rate and also have a substantial need to refinance their debt.

The higher interest rates require more firms to reduce their debt to keep the interest rate expenses from soaring and thus putting pressure on their results. Additionally, the firms must be able to amortise and refinance their pending maturities. In coming years, large maturities will need to be refinanced at considerably higher interest rates (see Finansinspektionen, 2023b). In addition to managing maturities, in some cases firms also need to take action to uphold their credit rating or to meet lenders' financial conditions (covenants).[4]

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[1] The Swedish CRE market is large, sensitive to economic fluctuations and closely connected to the financial system through the banks' considerable lending to CRE firms. Historically, problems that have arisen on the CRE market have either triggered or amplified financial crises.

[2] The most recent decision was made on 12 September 2023 and entered into force on 30 September 2023 (see Finansinspektionen, 2023a). See also Finansinspektionen (2020) for information regarding previously announced decisions.

[3] For a more in-depth discussion, see for example Finansinspektionen (2019).

[4] Covenants are loan conditions formulated as a commitment on the part of the borrower to, for example, maintain certain levels of financial key figures when lenders issue loans to firms. Lenders use covenants to reduce their lending risk.

Firms can reduce their debt by

- using the business's cash flow to pay back loans
- taking in new capital by issuing equity (replacing loans with equity)
- lowering or cancelling dividends
- selling parts of their properties or other assets
- combining these methods.

Some CRE firms have started to reduce their debt. Since autumn 2022, CRE firms have collected close to SEK 40 billion in equity issuances and sold properties for more than SEK 70 billion.[5] Lowered and cancelled dividend payouts have also contributed but have freed up considerably less capital. In part, this can be due to the differences in the firms' dividend policies. Though some CRE firms have considerably lowered their dividends this year, many have actually increased them compared with the previous year. In total, dividends have nonetheless decreased from SEK 12 billion to SEK 5 billion between the first three quarters of 2022 and 2023. Many CRE firms have also planned for and begun to reduce investments in new projects.[6] Though the firms' investments in existing stock have declined in Q3 2023, they nonetheless continue to be relatively high: just over SEK 16 billion in total. Thus, there is a certain amount of room for reducing expenses and freeing up capital in the short term.

During the third quarter, CRE firm debt fell by about SEK 20 billion. However, prolonged higher interest rates require CRE firms to further reduce their debt to levels that are more sustainable in the long term. If the debts remain on current levels, the CRE firms' interest coverage ratio (ICR) and loan-to-value (LTV) will deteriorate as the debts are refinanced at higher interest rates and yield requirements increase. CRE firms with a low ICR that are highly leveraged and have short interest rate adjustment periods are particularly vulnerable to prolonged high interest rates and may need to take measures to adjust their business and strengthen their balance sheet.

In this FI Analysis, we estimate how much Swedish listed and larger privately owned commercial real estate firms need to reduce their debt in a climate of rising financing costs and falling property values.[7] We calculate how much the firms need

[5] This information has been obtained from the firms' interim reports.

[6] The number of building permits for new builds and already started new builds of apartments in multi-dwelling buildings dropped by 62 per cent and 74 per cent respectively in Q2 2023 compared to the year prior.

[7] The analysis includes a selection of 72 large CRE firms. The Swedish CRE market includes substantially more firms. Small- and medium-sized CRE firms in particular make up much of bank lending. However, these firms are generally less transparent compared to larger firms that regularly publish quarterly reports.

to reduce their debt to maintain certain interest coverage and LTV ratios.[8] We need to use specific thresholds for making these calculations. It is not necessary for the firms to reach these exact thresholds in practice. Instead, the thresholds function as limit values in the analysis and give an indication of different risk levels.

Both the interest coverage and LTV ratios are often used as financial covenants in loan agreements and are commonly used by credit rating institutions in assessing a firm's creditworthiness.[9] Financial covenants are important for providing early warning signals. As a result of violating a covenant, borrowers may need to take certain measures such as pledge additional collateral or make extra amortisation payments. Lenders may also increase their loan margin by charging an extra risk premium or imposing other restrictions.

For firms that do not meet certain key indicator thresholds, the credit rating institutions may lower their credit ratings. If the rating is reduced from investment grade to non-investment grade, certain actors may not be able to invest in the firm's bonds because their investment rules do not allow it, making it more difficult for the firm to obtain market financing.[10]

Rising interest rates weaken the ICR

The average interest rate of the total debt of the CRE firms rose from just under 2 per cent at the beginning of 2022 to about 3.8 per cent at the end of Q3 2023. At the same time, the average interest rate of new bank loans was just over 5.5 per cent.[11]

Because the interest rates of CRE firm loans are fixed for different maturities, the entire interest rate increase has not yet fully taken effect on their interest rate costs. This suggests that the CRE firms' financial costs will continue to rise as the periods of fixed interest and tied-up capital mature and are refinanced.

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[8] The ICR is the ratio between a firm's operating result and its financial costs that describes the firm's ability to pay interests on loans. The LTV ratio is interest-bearing liabilities in relation to property values.

[9] The financial covenant for the ICR is generally between 1.5 and 2.0, though banks may allow lower levels. Banks often apply about a 60 per cent LTV ratio as an internal cap when lending money to CRE firms. Credit rating institutions generally apply a 50–60 per cent LTV ratio for an investment grade rating (see Moody's 2022).

[10] A credit rating is an assessment of a firm's ability to fulfil its financial commitments. Investment grade and non-investment grade or high yield are market conventions and are generally used to describe higher and lower creditworthiness levels.

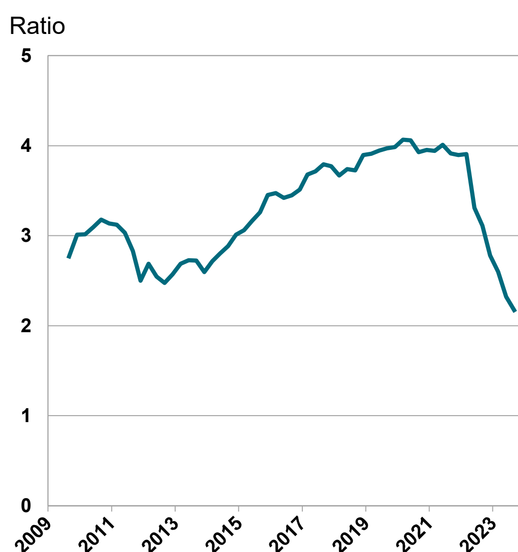
[11] CRE firms that issue debt on the bond market often encounter even higher interest rates.

Rising interest rates have caused the ICR to fall quickly from about 4 to closer to 2 for several CRE firms (see Diagram 1). If the CRE firms' financing costs rise to 5 per cent, with all else being equal, the ICR of the majority of CRE firms will drop below 2 (see Diagram 2).[12] Almost half of the CRE firms will end up with an ICR below 1.5 and about one in every six firms will not even reach a ratio of 1.

There are no absolute measures of when a firm's ICR is so low that it will experience financial difficulties. However, if the ICR is lower than 1, this means that the firm cannot make its interest payment with income from its operating activities. As such, it is not sustainable in the long term for the ICR to remain under 1 for a prolonged period of time.

1. CRE firms' ICR

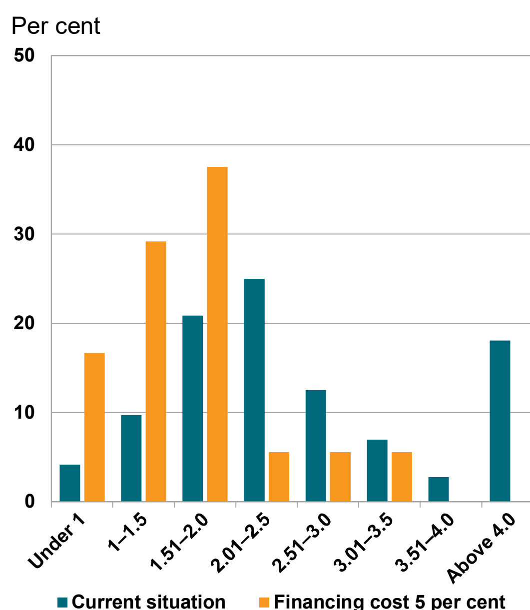
Ratio



Source: FI and Sedis.
Note: Refers to a median of a 12-month rolling ICR for listed and larger privately owned CRE firms. Data refers to the period up to an including Q3 2023.

2. Distribution of the CRE firms' ICRs

Per cent



Source: FI and Sedis.
Note: The current situation shows the ICR from the most recent interim reports. Financing cost 5 per cent shows how the distribution shifts if the financing costs increase to 5 per cent.

[12] We have based our assumption of CRE firms' financing costs rising to 5 per cent on the prolonged high interest rate for the policy rate forecasted by the Riksbank. Even if the interest rate for new bank loans is currently higher than 5 per cent, there will be less of an impact on the firms' average interest rates. Interest rates go up gradually as loan and interest rate derivatives fall due.

Pressure on property values

The value of commercial real estate in Sweden has dropped by approximately 6 per cent since its peak in Q2 2022 (see Diagram 3). Higher interest rates and the need for commercial real estate firms to reduce their debt may put additional negative pressure on real estate values. The implicit pricing of real estate assets via the listed firms' share prices further indicates that the stock market expects such a development.

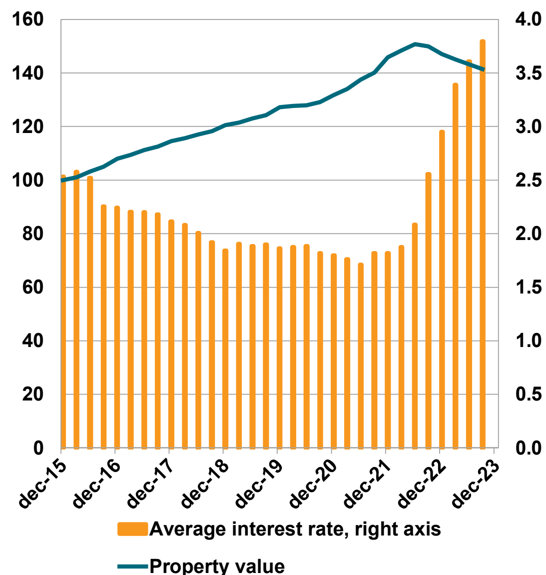
In simplified terms, the value of a commercial property can be seen as the discounted present value of the operating surplus (or net cash flow) that the property is expected to generate over time. The discount rate is the risk-free interest rate plus the risk premium investors require as compensation for the uncertainty in the future cash flow. It can be viewed as the investor's yield requirement when acquiring a property. When the interest rate in the economy rises, investors' yield requirements should also increase in order for the risk compensation to remain the same. A higher yield requirement entails that the future cash flow must be discounted at a higher rate of interest, which, all else being equal, leads to lower real estate values.

To date, however, the real estate values have not dropped as much as could be justified by the higher interest rates and financing costs. This could partially be explained by CRE firms exercising restraint in writing down the value of their properties. Real estate valuers seem to often set higher evidence requirements before devaluing real estate (see BREC, 2023). It is also difficult to make valuations as relatively few properties have been sold, making it difficult to observe actual market values.

Despite rising interest rates, the firms have been restrictive in upwardly adjusting the yield requirements. This is related to the limited downturn in the reported real estate values (see Diagram 4). According to earlier historical correlations, the increase from 0 to 2.5 per cent in the risk-free interest rate that took place between 2021 and 2023, should lead to an increase in the yield requirement by about half of the increase in interest rates (see Aranki, et al., 2020). According to this estimation, the yield requirement for commercial real estate in Sweden should therefore currently be around 6 per cent.

3. Real estate values and average interest rate

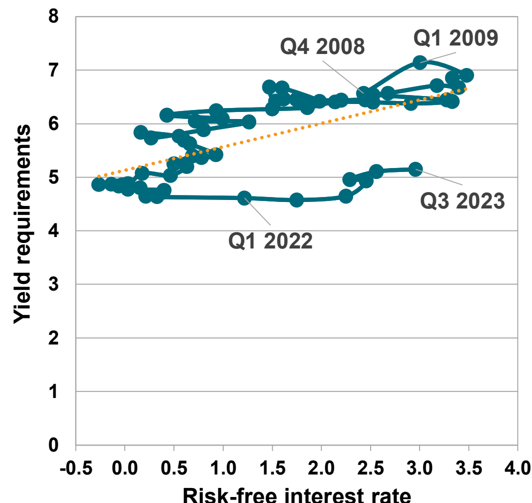
Index, Q4 2015=100 and per cent



Source: FI and Sedis.
Note: Refers to the average interest rate cost and property values for listed and larger privately owned commercial real estate firms up to and including Q3 2023.

4. Interest rate and yield requirements on commercial properties

Per cent



Source: The Riksbank and Sedis.
Note: The risk-free interest rate refers to the Swedish ten-year treasure bond. The dashed line shows the estimated linear correlation between the firms' yield requirement and the risk-free interest rate for the period Q4 2008–Q3 2023.

Changes in the property values can be calculated given certain assumptions regarding the development of yields and net operating income (see Table 1). Our calculations indicate that if yields increase to just over 6 per cent, the market values would decrease by 13–29 per cent. How much the values would decrease also depends on what happens to the firms' earnings (net operating income) at the time.

Tabell 1. Calculated change in market value for different scenarios

Per cent

Yield requirements	Net operating income -10 per cent	Net operating income 0 per cent	Net operating income +10 per cent
4.80	-10.0	*outcome*	10.0
5.05	-14.5	-5.0	4.6
5.55	-22.2	-13.5	-4.9
6.05	-28.6	-20.7	-12.7

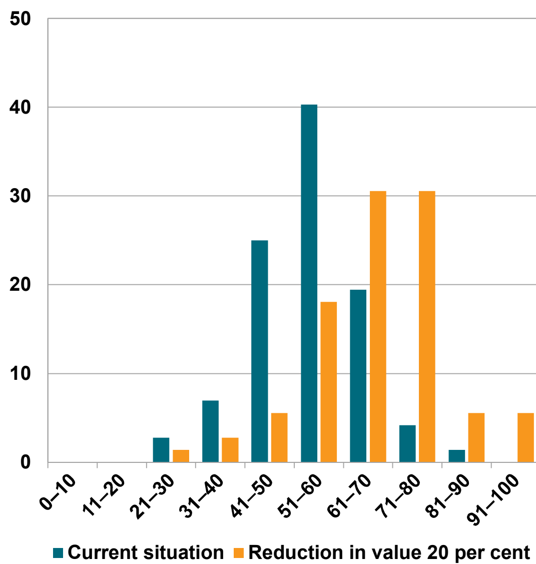
Source: FI.
Note: The table shows the percentage change in the market value based on the following formula: market value = net operating income/yield. The change is calculated in relation to the *outcome* when the yield requirement is 4.8 and the net operating income is 0 per cent.

If the real estate values drop, the LTV ratio increases, all else being equal. In a stressed scenario in which the real estate values drop by 20 per cent, over 40 per cent of the CRE firms will have an LTV ratio above 70 per cent (see Diagram 5). These represent almost 65 per cent of CRE firms' interest-bearing liabilities. This can be compared to the 6 per cent that already have a current LTV ratio above 70 per cent but only represent 1 per cent of the liabilities.

Firms with a high LTV ratio also generally have a low ICR (see Diagram 6). Therefore, certain firms already need to reduce their debt to avoid an ICR under 1 or an LTV ratio above 70 per cent. These are benchmarks used by FI to identify vulnerable CRE firms (see Aranki et al., 2020). In the stressed scenario, where the financing costs rise to 5 per cent and the real estate values drop by 20 per cent, around 15 per cent of firms become vulnerable. These represent about one-third of the total interest-bearing liabilities.

5. Distribution of CRE firms' LTV ratios

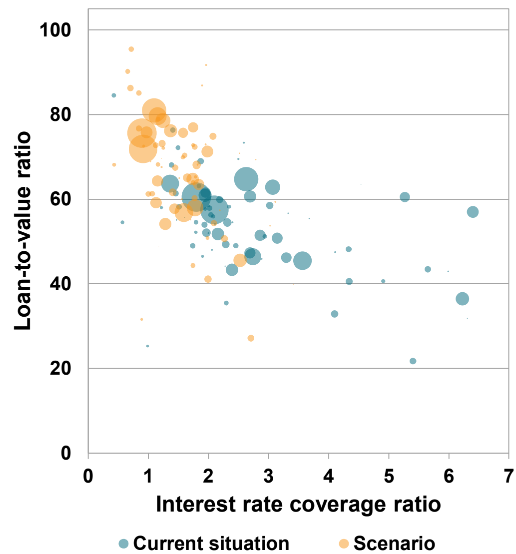
Per cent



Source: FI and Sedis.
Note: The current situation shows the CRE firms' LTV ratios from the most recent interim reports. The reduction in value 20 per cent shows how the distribution in LTV ratio shifts under the assumption that the real estate values drop by 20 per cent.

6. CRE firms' interest coverage and LTV ratios

Ratio and per cent



Source: FI and Sedis.
Note: The current situation shows the CRE firms' interest coverage and LTV ratios from the firms' most recent interim reports. The scenario is a calculation that assumes that the firms' financing cost increases to 5 per cent and the real estate values drop by 20 per cent. The size of the bubble reflects the size of the firms' total interest-bearing liabilities.

Great need for debt adjustment

Above, we have shown that several CRE firms may encounter problems and become vulnerable in a scenario in which financing costs rise to 5 per cent and real estate values drop by 20 per cent. FI defines CRE firms as being vulnerable if they have an ICR under 1 and an LTV ratio over 70 per cent. Both of these criteria must be fulfilled for a firm to be categorised as vulnerable.

Lenders and credit rating institutions often specify conditions or thresholds on individual indicators separately. They also use less strained levels such as ICRs between 1.5 and 2.0 or LTV ratios of a maximum of 50–60 per cent. The purpose is to capture early warning signals of potential problems and enable firms to take measures before becoming vulnerable. We have therefore made calculations for stricter thresholds of the firms' interest coverage and LTV ratios than those FI assumes to identify vulnerable firms. This may be justified if the firms need to maintain such levels to keep their credit ratings or to fulfil their covenants.

Aside from CRE firms being able to reduce their debt through equity injections (new issues), we also present calculations for firms instead selling properties and using the capital to amortise debt. These calculations show just how much real estate needs to be sold to reach the same debt reduction as through new issues.

The firms' need to maintain the ICR is particularly strained

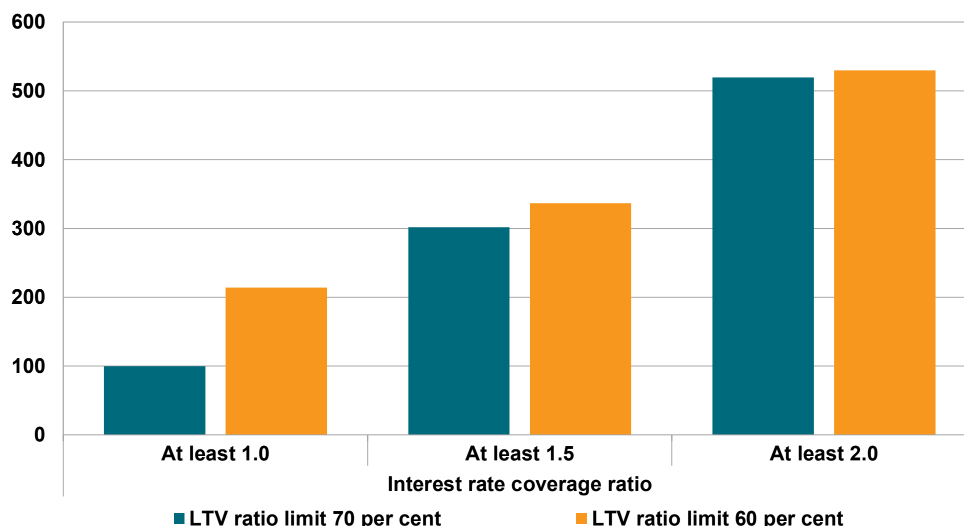
In a scenario in which financing costs rise to 5 per cent and real estate values drop by 20 per cent, many firms will need to reduce their debt, especially those that are currently highly leveraged.

For each CRE firm to avoid an ICR under 1 and an LTV ratio above 70 per cent in such a scenario, a total debt reduction of about SEK 100 billion is required (see Diagram 7). This amounts to an average debt reduction of around 15 per cent for the firms that need to reduce their debts. For each CRE firm to reach an ICR of at least 1.5 and an LTV ratio of at most 70 per cent, a debt reduction of over SEK 300 billion is needed. This corresponds to just over 20 per cent of the CRE firms' current debt.

The need to reduce debt increases significantly if we assume that the firms strive to maintain an ICR of at least 2, providing a greater margin of safety for themselves and their lenders. More than half of the total need to reduce debt comes from a few CRE firms with substantial debt.

7. Debt reduction for reaching a particular interest coverage and LTV ratios in a scenario with higher interest rates and lower real estate values

SEK billion



Source: FI.

Note: The diagram shows how much the CRE firms' debt must be reduced for the ICR to remain over 1, 1.5 or 2 and the LTV ratio to remain under 70 per cent and 60 per cent respectively in a scenario in which the CRE firms' financing cost rises to 5 per cent and the real estate values drop by 20 per cent.

Maintaining a certain ICR requires greater debt reduction from CRE firms than only maintaining the LTV ratio. If, in this scenario, the firms strive to raise their ICR from, for example, 1.0 to 1.5, they would need to make relatively high reductions to their debt compared to if they strive to lower their LTV ratio from 70 to 60 per cent.

By raising their ICR, the firms will also lower their LTV ratio. For firms that reduce their debt to keep their ICR from falling below 1.5, the average LTV ratio is just over 55 per cent. For an ICR threshold of at least 2.0, the LTV ratio is even lower, on average about 50 per cent.

If instead of reducing their debt, the firms attempted to increase their operating profit to improve their ICR, our calculations show that the increase would have to be substantial.[13] In the same scenario, the operating profit would need a median increase of about 30 per cent to reach an ICR of at least 1.5. This would require certain firms to more than double their operating profit.

Given the current state of the economy, it would probably be difficult to solely adjust the operating profit. For example, greater vacancy rates could result from making major hikes to rental charges, thus counteracting improvements to the

[13] Firms can increase their operating profit by increasing earnings or reducing operating costs.

bottom line. For residential properties, rental regulations also impose restrictions. It is therefore more conceivable that firms would combine measures to strengthen their financial position. In practice, this will probably take different forms and take place over a long period of time. Regardless, it is important that the firms ensure a satisfactory cash flow to enable them to pay their recurring interest costs.

Real estate sales require larger amounts

Firms can take various different measures to reduce their debt. Above, we have calculated the amount of equity injections (new issues) that would be needed to decrease debt. If the firms were, instead, to decide to sell property and use the freed-up capital to amortise their debt, they would on average need to sell for about double the amount to reach the result obtained from issuing equity (see Diagram 8).

Equity issuance and property sales are different in that the entire equity can be used to reduce debt, while sales does not free up as much capital as the properties are leveraged. These liabilities need to be repaid before the remaining income from the sale can be used to reduce other debt.[14] In addition, to sell real estate there needs to be a demand from other investors as several CRE firms are limited in their financial positions. [15] Selling properties also entails a reduction in the firms' rental income.

A few CRE firms with large property portfolios represent more than half of the aggregate sales need. According to our calculations, it would require CRE firms to sell relatively large portions of their current portfolio to reduce their debt to long-term sustainable levels (see Diagram 9). To avoid an ICR under 1 and an LTV ratio above 70 per cent in the scenario, the firms need to sell off over 10 per cent of their property portfolio on average, though one-fourth will need to sell off about 15 per cent.

If the firms aim to maintain an LTV ratio of no higher than 60 per cent, one-fourth of the firms will have to sell off at least 30 per cent of their property portfolio. The proportion that needs to be sold increases the stricter the thresholds used. Using the strictest thresholds, the firms will need to sell more than 25 per cent of their property portfolio on average. In a scenario where several firms need to sell off a

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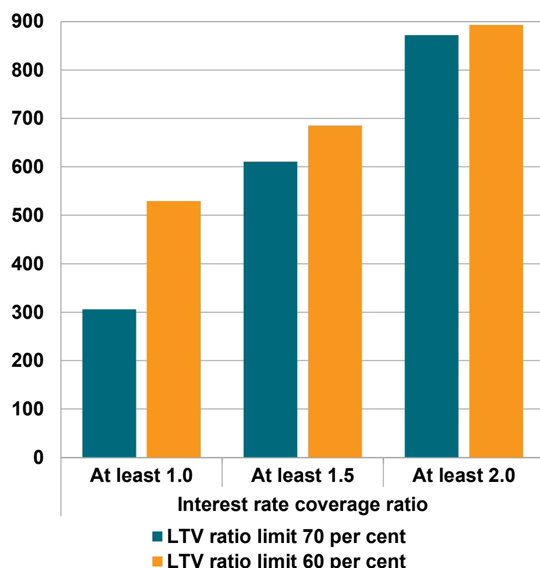
[14] The higher the LTV ratio, the more real estate needs to be sold to obtain the same reduction in the LTV ratio as in a case with a lower LTV ratio. If a firm sells a property at a loss, it will have a negative impact on the outcome, thus weakening equity. If the equity ratio drops too low, it can be more difficult for firms to use property sales to reduce their debt. On average, the firms' equity ratio is currently 40 per cent, and the sector's total equity amounts to almost SEK 1,300 billion.

[15] There are actors that may be prepared to increase their exposure to the real estate sector. Among other things, there is capital available among Swedish investment funds and other long-term managers to meet some of the sector's need for capital.

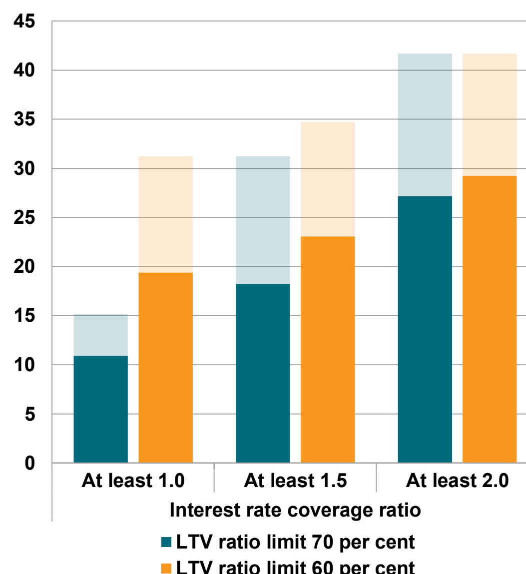
substantial number of properties, the increase in supply may put additional pressure on the real estate values, and in the worst case, lead to a self-reinforcing process.

8. Sell-off needed for debt reduction
SEK billion



Source: FI.
Note: The diagram shows the CRE firms' total need for property sell-off to reduce debt and maintain given levels of interest coverage and LTV ratios in a scenario in which the CRE firms' financing cost rises to 5 per cent and the real estate value drops by 20 per cent.

9. Proportion of property portfolio needing to be sold
Per cent



Source: FI.
Note: The diagram shows the average (solid bar) and the 75th percentile (shaded bar) of the firms' proportion of the property portfolio needing to be sold off to maintain given levels of interest coverage and LTV ratios in a scenario in which the CRE firms' financing cost rises to 5 per cent and the real estate value drops by 20 per cent.

The CRE firms can also sell off financial assets consisting of participations and receivables in group and associated companies, other long-term securities holdings, loans to co-owners and other long-term receivables. The firms' total financial assets approach SEK 145 billion. However, only a proportion of the total financial assets could be sold and used to repay debt. This is due to the fact that not all firms that possess assets are in need of reducing their debt in the scenarios, nor is it certain that the entire financial assets' value can be realised from the sale.

Basically, all of the firms' financial assets amount to less than 10 per cent of their property values. For the majority of the firms, it would therefore not be enough to only sell these assets to reduce debt, even if doing so can contribute to reducing the firms' debt or need to sell off real estate.

Conclusions

This FI Analysis shows that Swedish CRE firms need to take measures to achieve secure interest coverage and LTV ratios in an environment characterised by higher interest rates. For many firms, it will most likely not be enough to only improve their operating profit or reduce their dividends. It would also require firms to reduce their debt through new equity or property sales. Several firms have already begun to reduce their debt.

In a scenario in which financing costs rise and property values drop, several more firms may need to increase their equity, sell off parts of their property portfolio or reduce their debt by other means. In our estimation, raising the ICR would require more debt adjustments than reducing the LTV ratio. For the firms to reduce their debt through the property sales, they would need to achieve about twice the amount compared to if they were to bring in capital through issuing equity.

More than half of the total need for adjustment pertains to only a few CRE firms. This entails that there are concentration and contagion risks from these firms, which, in the worst case, can lead to a self-reinforcing process where forced sales drive prices down.

Therefore, more CRE firms should take action to fortify their financial position such as through new equity or property sales, and thereby reduce their risks and vulnerabilities. In practice, firms will most likely adjust their financial position in various ways and over a long period of time. The adjustment process can have an impact on the real estate market and on financial markets, which FI needs to continue monitoring.

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