Tapping new sources

Will alternative property financing close the gap?

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The credit crisis showed that liquidity in the banking sector can dry up drastically. It also became apparent that an illiquid credit market has negative effects on the property market. For example, many property investors could not get acquisition financing at reasonable terms and as a consequence attractive investment opportunities were missed. What financing options are available post-crisis as alternatives to traditional bank debt? How can property investors take advantage of these opportunities?

Introduction

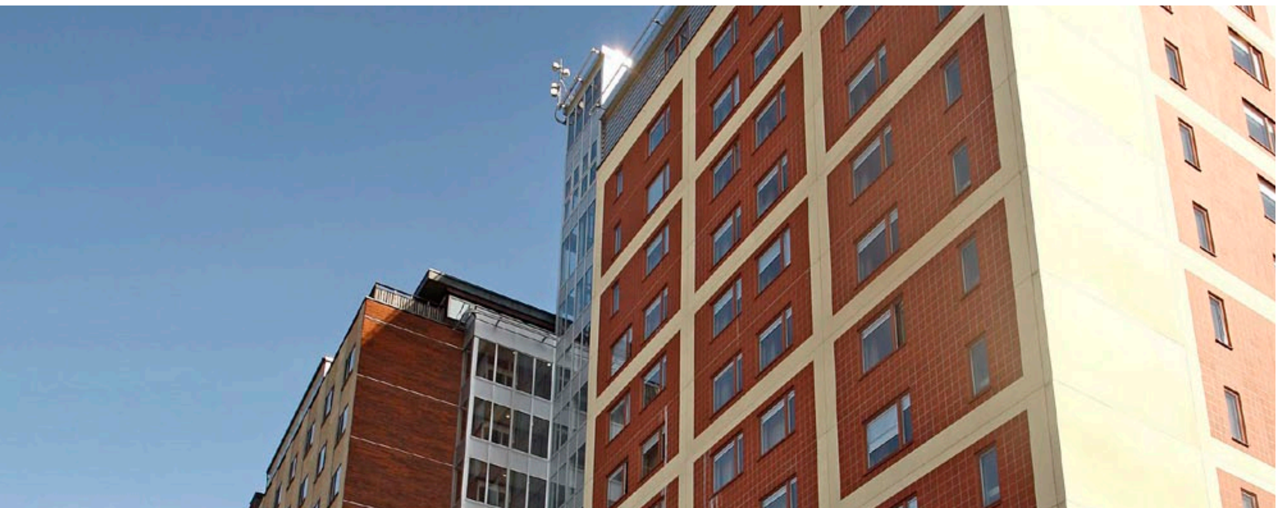
A significant part of all bank debt to the corporate sector in Sweden is maturing in the near future. Property companies alone have bank debt of approx. SEK 500 billion maturing between 2011 and 2013, often syndicated between different banks.[(1)] The most challenging loan stock to refinance is probably syndicated foreign bank debt that were originated in 2006-2007 often with high loan-to-value ratios.

Foreign banks hold some 20 per cent of the bank debt in Sweden[(1)]. Many of these banks would like to reduce their existing loan portfolios in the Nordics, partly as a consequence of Basel III:s rules on capital and risk control, partly as a consequence of problems in their 'home' markets.

As a result of this borrowers need to start looking for alternative financing sources, such as bonds and hybrid capital that can replace and complement traditional bank debt.

Funding costs for banks are still substantially higher than before the financial crisis. This translates into relatively high margins on bank financing to the property sector. Outside the property sector large corporations have increasingly tapped capital markets (mainly bond markets), where pricing may be more attractive. This has not yet materialised to any great extent in the Nordic property sector. In the following sections we will present instruments and opportunities that are available to property investors in the Nordics today.

(1) According to the report: 'Den svenska obeståndsmarknaden' (Distress in the Swedish market), March 2010. This also refers to non-listed property companies.



Traditional bank debt

The banking sector has been by far the largest and most liquid source of financing. Historically, it has been relatively easy in Sweden to get attractive bank debt with high loan to value ratios, in particular in connection to property acquisitions. However, due to the credit crisis the situation changed drastically. The lending capacity in the banking sector was severely reduced and financing was almost non-existing for, in particular, new bank customers and high-risk investments. The health of the Nordic finance industry has however improved significantly since then and hence the possibility to raise bank debt has improved, although not to the same extent as before the crisis. The upcoming Basel III rules for capital adequacy and risk control in the banking sector will also likely reduce LTV-levels and increase the cost of borrowing going forward.

On the other hand, the decreased appetite for bank debt from the corporate sector in general has actually led to an increase in financing available from banks to the property sector, pushing margins down, albeit from extremely high post-crisis levels.

Alternative financing sources

Bonds

In addition to traditional bank debt, companies can tap capital markets for financing, for instance by issuing bonds *(Sw. obligationer)*. There are both secured and unsecured bonds (i.e. secured by an underlying asset such as a property), which has an effect on the risk level for the bondholder.

Bonds can be structured in many ways with a fixed payable interest ('coupon'), a predetermined interest amount which is paid upon maturity ('zero-coupon') etc. These bonds are often traded on secondary markets and can be rated by credit institutions.

From an international perspective, the size of the Swedish and Finnish bond market is quite limited and the market is relatively undeveloped. The interest among companies for issuing bonds has, however, increased notably in the last years as a result of the illiquid banking sector. Internationally, bond markets are an important source of financing for property companies.

Outside the property sector, the pricing of bond financing is attractive compared to bilateral bank debt. Assuming property investors could benefit from the same price differential, there is an opportunity for property investors to reduce borrowing costs by going to capital markets.

Debentures

Debentures *(Sw. förlagslån)* are unsecured debt instruments issued by companies or banks. Since the instruments are not secured by any physical assets or collateral, the interest rate is normally higher than for traditional bonds. Debentures are senior to equity but subordinated to bonds and bank debt.

Mezzanine

As a complement to traditional senior bank debt (e.g. to finance a property portfolio) it is not uncommon to use a junior debt tranche (or 'mezzanine'). This is essentially debt with a secondary right to the security (e.g. the mortgaged property) whereby the holder of the senior debt has the first right to be paid in a liquidation situation whereas the holder of the junior debt has a prioritised right to the equity owner. This implies a higher risk for the mezzanine lender and therefore the the interest rate is higher than that of the senior debt.

By adding a mezzanine tranche leverage can be increased beyond the levels supplied by banks, without having to tap capital markets.

Preferred equity

Preference shares *(Sw. preferensaktier)* are hybrid instruments with features of both equity (voting rights) and debt (fixed dividend). Normally, the owner of preference shares is entitled to an annual fixed dividend and voting right in the company. The voting power is often lower than for ordinary shares. Preference shares are senior to ordinary shares but subordinate to debt.

From the perspective of the common shareholders, the main advantage of preferred equity is that while holders of preferred equity are offered a debt-like cash flow (without any share in the upside), the company has the option, in a distressed situation, to stop paying dividends to the preference share holders, without running into insolvency.

A combination of common equity, preferred equity and debt makes it possible to split risk and reward efficiently between investors with different investment and risk profiles. The main drawback of preferred equity is that it is not tax efficient compared to debt and other forms of hybrid capital.

Profit-sharing loans

A profit-sharing loan *(Sw. vinstandelslån)* is a loan where the interest rate is entirely or partly linked to the company's profitability. Similar to convertibles, the idea is that holders of the profit-sharing loan and the shareholders share the company's risk and potential upside.

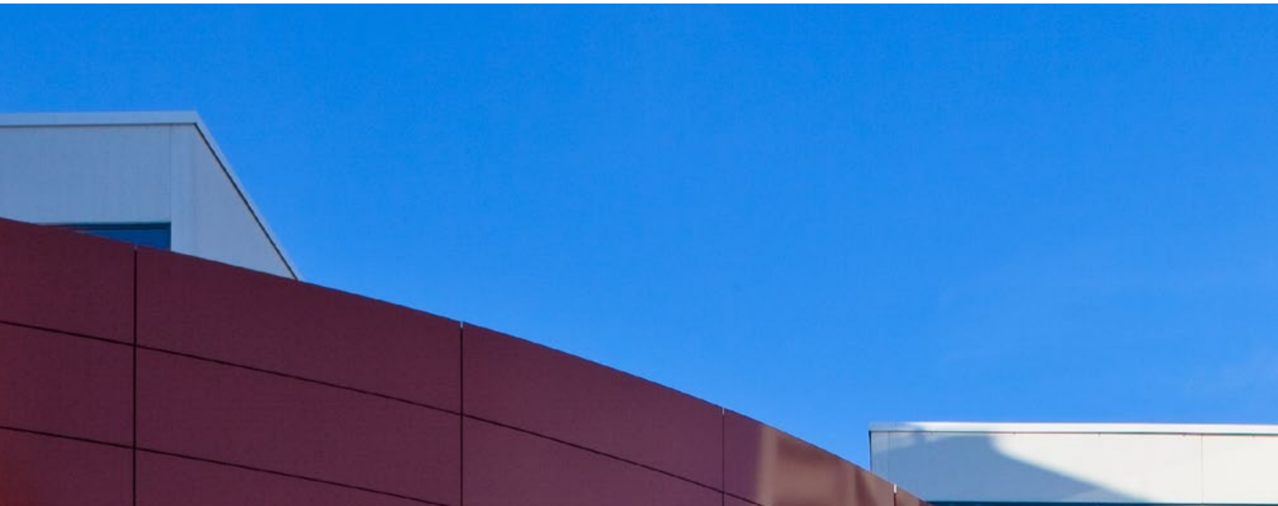
Profit-sharing loans are similar to equity in the sense that the holder gets a share of the profit. On the other hand the holder does not have a voting right.

The main benefit of profit-sharing loans is that they are tax-efficient, particularly in jurisdictions without thin capitalisation rules (e.g. in Sweden and Finland as of now).

Convertible bonds

Convertible bonds *(Sw. konvertibla förlagslån)* can be seen as debentures (see above) with the right for the holder to convert the loan into shares in the company. Normally, this conversion can be done at a predetermined share price and after a certain point in time. The interest rate for convertibles is normally lower than for traditional debentures, but the conversion possibility gives the holder a potential upside. Upon liquidation, convertibles have higher priority than equity but lower priority than other bank debt and bonds.

Convertibles are commonly used in financially distressed situations where a company needs to raise financing and has difficulties tapping bank financing and ordinary bonds are not attractive enough to investors. If the company becomes profitable again, the buyer of the convertibles receives part of the upside by becoming a shareholder in the company.



Summary

Type of capital	Debt				Hybrid capital		
Instrument	***Bank debt***	***Bonds***	***Debentures***	***Mezzanine***	***Preferred equity***	***Profit-sharing loans***	***Convertible bonds***
Interest rate/dividend yield	Low	Low/Medium	Medium/High	Medium/High	Medium/High	Medium/High	Medium/High
Risk	Low	Low/Medium	Medium/High	Medium/High	Medium/High	Medium/High	Medium/High
Potential upside	No	No	No	Sometimes	No	Yes	Yes
Voting power	No	No	No	No	Low	No	Yes, after share conversion
Tax efficiency	High	High	High	High	Low	High	n/a
Publicly traded	No	Yes	Sometimes	No	Yes	No	Sometimes

Securitisation

Securitisation *(Sw. värdepapperisering)* is the bundling of cash flows coming from a portfolio of loans or leases with identical or similar profile into a bond which is sold to investors. Securitisations have historically been used by credit institutions with large pools of loans with very similar characteristics (e.g. residential loans, asset leases etc.). The pool of loans is then transferred to a separate vehicle which in turn is financed through the issuance of bonds secured either by a mortgage in the underlying assets (mortgage backed securities) or by the cash flow from the underlying loan pool (asset backed securities).

In certain instances, there are sound arguments for the use of securitisations on the property market. In order to be successful, there will need to be a relatively long (10+ years) and predictable cash flow which is secured by a strong credit counterpart (e.g. governmental/municipal risk or high investment grade). The idea is to tranche the risks so that property risk, residual value risk and credit risk are borne by different parties, whereas the bond investor (i.e. the buyer of the security in a securitised structure) is exposed solely to the tenant credit risk. If the prerequisites are fulfilled there could be an opportunity for an arbitrage gain of up to 1-2% thanks to lower cost of capital as well as increased leverage without tapping into ordinary banking facilities.

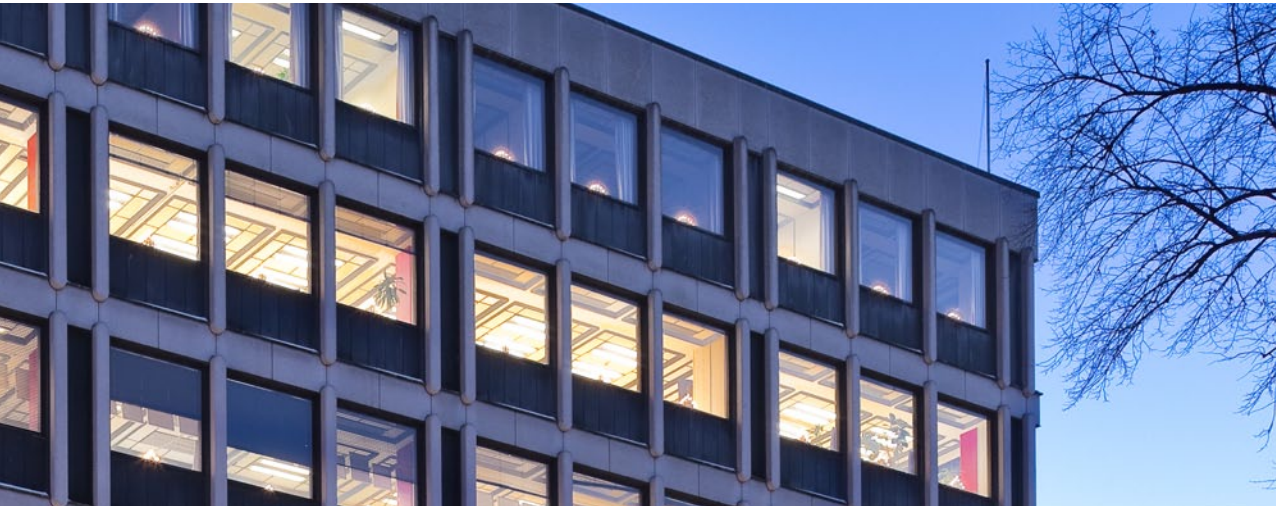
The use of alternative financing sources by Swedish and Finnish listed property companies

Current financing for Swedish and Finnish listed property companies

Company	Interest bearing debt [1]	Bonds	Preference shares	Convertible bonds
Atrium Ljungberg	8,841			
Balder	9,740	√		
Brinova	3,514			
Castellum	15,412	√		
Catena	1,052			
Corem	3,782	√	√	(√)
Dagon	3,607			
Diös	2,782			
Fabege	16,762			
FastPartner	3,013	√		
Heba	1,217			
Hufvudstaden	3,600			
Klövern	7,536			
Kungsleden	13,898	√		(√)
Sagax	5,557	√	√	
Wallenstam	12,878			
Wihlborgs	9,262			
TOTAL SWEDEN, SEK million	**122,453**			
Sponda	1,421	√		
Citycon	1,580	√		√
TOTAL FINLAND, EUR million	**3,001**			

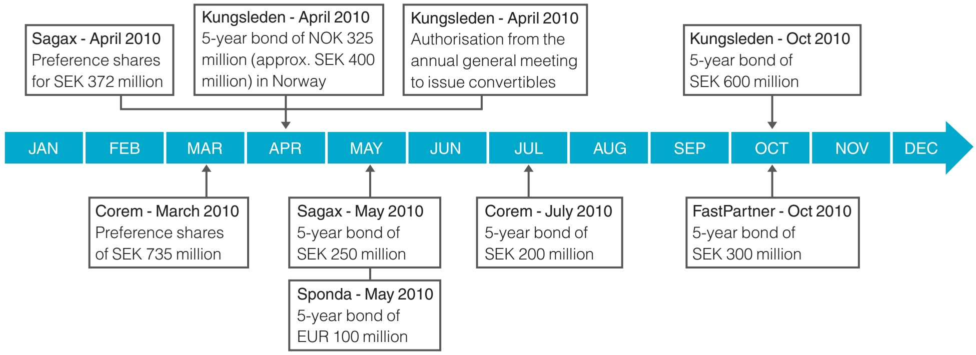
[1] As of September 30, 2010

(√) Authorisation from the annual general meeting to issue convertibles



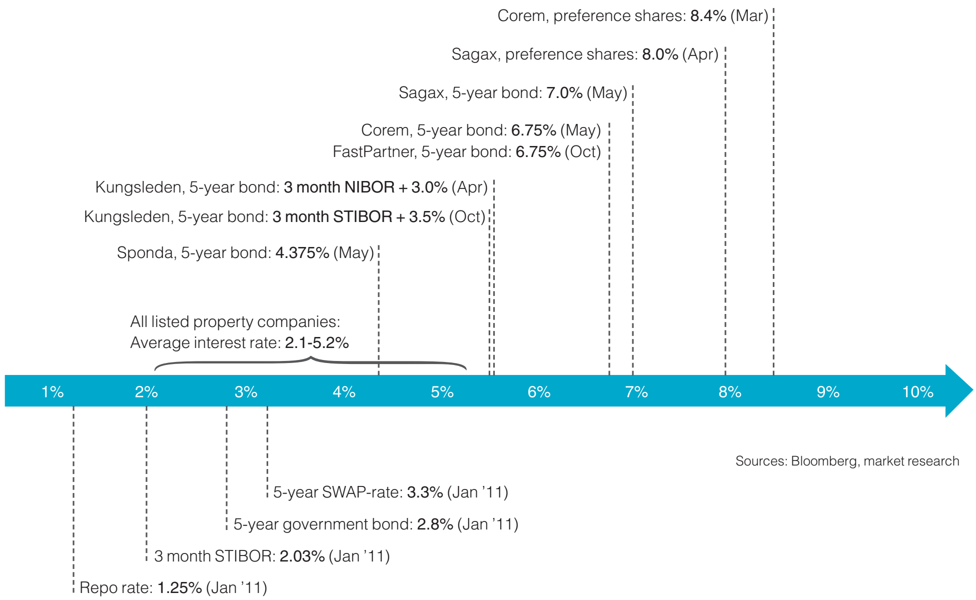
Alternative financing issuance in 2010

In 2010, several listed property companies used capital markets as a complement to traditional bank financing. Sponda, Kungsleden, Corem, FastPartner and Sagax are the companies that have been the most active as shown below.

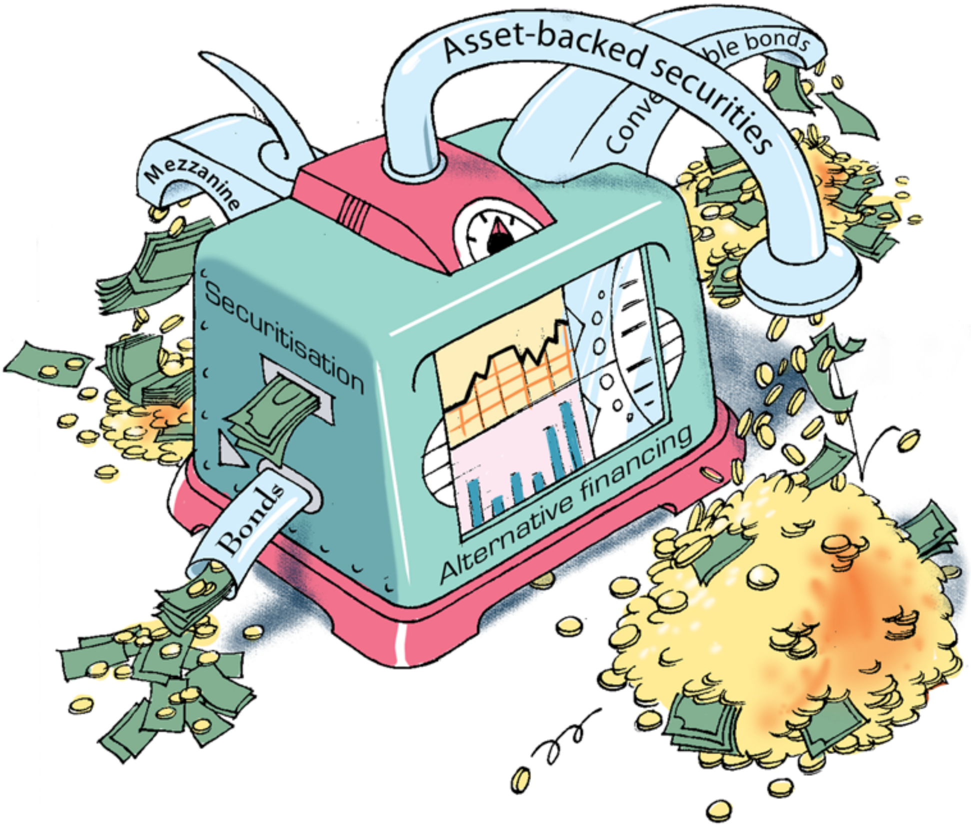


Pricing of alternative financing in 2010

The pricing of different instruments is related to the risk associated with each instrument, as well as the characteristics of the company issuing the instrument. The chart below illustrates examples of pricing of instruments in the Swedish and Finnish market.



Sources: Bloomberg, market research


Asset-backed securities
Mezzanine
Securitisation
Bonds
Alternative financing

Conclusions

There is plenty of opportunity among investors on the Swedish and Finnish property markets to refine their financing arrangements in order to improve the capital efficiency and increase returns. With the introduction of Basel III, other sources of financing than traditional bank debt will most likely increase in importance. Volatility on the financial markets is likely to continue over time both in terms of access to capital as well as the price of different financing sources. Therefore it is wise for companies to have several sources of funding to tap into in addition to traditional financing from their existing bank relationships. Examples of listed companies in Sweden and Finland who have discovered this and used it to a greater or lesser extent are Sponda, Sagax, Corem and Kungsleden.

As mentioned in this article, there are several ways to improve capital efficiency by using different instruments in the 'twilight' between debt and equity, such as mezzanine, bonds, debentures, profit sharing loans, preferred equity, etc. Additionally, the possibility to securitise the flow of rental income in a property company with particularly long lease agreements with investment grade tenants is a vastly undeveloped area in the Nordics that seems to offer interesting 'arbitrage' opportunities.

Needless to say, every company is different and would need to evaluate its options based on its own merits. Many aspects will affect the possibility to improve the capital efficiency, such as credit rating, existing loan covenants, tax position, equity owners risk appetite, interest sensitivity etc. In addition, timing is important given fluctuations on the markets, but the opportunity to improve both the financial flexibility and returns seems appealing.

As a conclusion, we are confident that many property owners (listed companies as well as privately owned) now have plenty of opportunity to improve the risk and return balance by evaluating and tapping these different and alternative sources of financing.