

Q1 2023 Earnings Call

Company Participants

- Christian Fladeland, Chief Investment Officer
- Helge Krogsbol, Chief Executive Officer
- Malin Lethenstrom, Head of Investor Relations
- Thomas Hansen, Chief Financial Officer

Other Participants

- Unidentified Participant, Analyst

Presentation

Operator

Welcome to Heimstaden Earnings Call for 2023.

(Operator Instructions).

I will now turn the call over to the speakers. Please begin.

Malin Lethenstrom {BIO 20287331 <GO>}

Thank you for joining us for Heimstaden Bostad's Financial Results for the first quarter of 2023. My name is Malin Lethenstrom and I'm head of Investor Relations.

I would like to inform all participants that this presentation is intended for investors and other stakeholders and should not be attended by the press or media. With me today I have our CEO Helge Krogsbol, our Chief Investment Officer, and Chief Financial Officer also with us and will shortly be introduced by Helge. They will over the next 15 minutes give a short update before we open up to questions.

We will hear only addressed questions on Heimstaden Bostad. The call will conclude at 9:00 Central European Time. Afterwards, as always, the Investor Relations team is available if you have more questions.

I will now hand it over to Helge.

Helge Krogsbol {BIO 22570841 <GO>}

Thank you, Malin. Good morning. Welcome to our first quarter review for 2023. My name is Helge Krogsbol and I am the CEO of Heimstaden.

As Malin mentioned, I'm here today with our Chief Investment Officer, Christian Fladeland, and our Chief Financial Officer, Thomas Hansen.

This is our first quarter presenting under this new format.

We thank you for the feedback and want it to be known that we actually listen to investor requests to improve with transparency and investor relations. Today we intend to keep management presentations relatively short as we want to get to open line Q&A as efficient as possible.

In today's presentation, our team will focus on the four themes presented on my slide.

From my perspective, fundamentals are increasingly more important for residential real estate as last year strengths are continuing into 2023. Despite these challenges, I'm proud to say we delivered a really strong operational result for the first quarter despite the negative impact on our property values.

My key priorities continues to be to deliver durable NOI growth through maintaining high occupancy levels, affordable rent increases and disciplined cost control throughout the business.

As I reflect on these topics, I'm reminded of the long-term commitments and high-quality relationships that we maintain with our shareholders as they continue to show tremendous support to Heimstaden Bostad through reinvestment and equity bond buybacks.

When I look ahead, I see that the fundamentals of residential real estate will remain intact and that we are well-positioned with our portfolio of affordable high-quality homes in stable European markets.

We will continue to focus on managing our financial risk by maintaining a strong liquidity position and be at the forefront of any upcoming maturities.

On that positive note, I'd hand it over to you, Thomas.

Thomas Hansen {BIO 17277464 <GO>}

Thank you, Helge.

Given the past pace of macro-environmental changes, Heimstaden Bostad continue to deliver a very strong operational result for the first quarter of 2023.

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In the current challenging financial markets, our focus has and will continue to be to deliver NOI growth as a key priority. This requires that we maintain high occupancy levels deliver on rent increases of generating key cost control measures.

I'm proud to say that the intentional measures that we've taken are all contributing to cash flows and reduce the negative valuation effect of yield expansion.

As you see on this summary shown in the slide, a number of our key operational KPIs performed quite strongly and a continuation of the previous trends.

We will spend some time to address each of these KPIs and several of the trends alongside the portfolio splits behind these figures in the coming slides.

Heimstaden Bostad continues to exhibit strong and stable occupancy trends, as real economic occupancy was sustained at 98.2% in Q1. The market sentiment with increasing demand and limited new build continues leaving occupancy at a stable and high level with rental growth momentum in all our core markets. The occupancy trend is especially strong in our regulated markets that include Sweden.

Some notable countries to highlight on a quarterly basis. Germany's occupancy improved as a result of upgrades to the country's internal reporting infrastructure which confirms the underlying trend of very strong occupancy results.

Our Finnish portfolio, though less than 1% of the entire portfolio, was affected by temporary high move-out rates. However, we experienced positive net change in lease in March.

U.K. and Poland constitute 1.4% of our entire portfolio and are impacted by delivery of new assets in U.K. In Poland, where previous delivery of new assets, have been left out during the quarter.

Like-for-like rental income growth came in at 4.8% compared to 5.4% in Q4 2022, slightly down from the comparable Q1 '22 figure which was 5.6%. Continued rental growth is tracking in line with core inflation.

We see the underlying rental in NOI growth has improved to our inflation hedge.

Our ambition to increase rents at least in line with core inflation remains in certain markets with some lag effects but we catch up over time in others.

As we will discuss later, the NOI protection that we have received from inflation is something that we have been able to offset significant part of the value decline that we would have seen from this yield expansion from a flat NOI.

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Here are some notable highlights for Q1. The decrease in Denmark is due to slightly higher vacancy level alongside a gross rent increase of 5.3%. The high growth in the Czech Republic, where inflation has been high, corresponds with rent indexation as the underlying market rents have increased. Decrease in growth in Norway is not due to rent growth which has been stable but slightly higher vacancy levels.

Finally, we note that the U.K. only includes 197 homes, of which 130 came online this quarter.

As we said in the 2022 year in review, we expected NOI growth in 2023 and the Q1 results follows our expectations. The 12 months rolling NOI margin improved by one percentage point up from 64.1% in Q4 '22 to 65.1% in Q1 '23. This growing margin across the portfolio demonstrates ability to pass on the inflation to a high extent. It's now that Poland and U.K. are in ramp-up phase and margins are not representable for the underlying business.

Total portfolio on the fair value basis declined by 3.9% for the quarter. Looking at the value growth across the markets that were present, we see that we have four markets which experienced positive early growth during the quarter. Rental increases and outlook outweighed the sentiment-based yield increase in these countries.

Across the remainder of our markets, we saw value decline in Sweden, Germany, Denmark, the Netherlands and Finland as sentiment-based yield increases where the contributing factor as there was limited comparable transactional support.

Here, we also saw that the yield expansion was not offset to a mature extent from the rental growth. The reason for this in particular is that the rental growth in these regulated markets is lagging.

In Sweden, Denmark and Finland, rallies were down primarily due to sentiment-based yield increase. In Germany, rallies were down primarily on OpEx increases and yield increases informed by a handful of small transactions.

In the Netherlands, rallies were down on real estate transfer tax increases alongside the negative HPI forecasts and yield increases.

In Czech, the U.K. and Poland, rallies were up due to strong rental performance despite the yield increases.

Finally, through Norway values were up due to an increase in HPI.

And with that, I pass it all to our Chief Investment Officer, Christian Fladeland.

Christian Fladeland {BIO 21623938 <GO>}

Thank you, Thomas.

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Looking at our credit metrics as of Q1 2023, we have seen a continued pressure on our ICR as forecasted in the last quarter standing at 2.5 as of Q1 '23 down from 2.7. This is in line with what we expected based on the increased interest rate curve but also due to the fact that we continue to pre-fund a lot of our upcoming maturities taking home more expensive debt earlier in order to reduce our refinancing risk. It is still well above our S&P BBB flat threshold that was reduced to 1.8 in December 2022.

Our net debt-to-cap ratio, the S&P-defined LTV increased from 52.6% to 55.5%, driven primarily by the fair value adjustments that Thomas just took you through.

In addition, we done a smaller impairment on our goodwill related to the Akelius transaction which also has a negative impact here. It also means that our internal financial policy which stated that we should maintain a net debt to cap LTV below 55% has been breached. They were breached by a small margin.

We will now, together with the Board and the shareholders, review our financial policy in order to see how it should accommodate the new environment that we are to navigate. This also ties together with an ICR that we believe will continue to be under pressure in the coming quarters and we need to evaluate in detail where we believe the level should be on a sustainable basis given the new environment.

Looking at our upcoming maturities.

We did a buyback during Q1 2023 of SEK10 billion funded by cash at hand as well as a new acquisitions. Following that, we have reduced our remaining maturities for 2023 to SEK7.3 billion which is well covered by our credit facilities.

In the coming years, we still anticipate that we will repay our bonds based on taking out additional unsecured financing.

We have taken out SEK12 billion in new secured financing during Q1 2023 and we still see that we have very good access in the banking market. There is no doubt that banks have become much more selective on the assets and their counterparties, but we still see that residential and we are one of the preferred ones even though we still suffer from the lower LTV obtainable due to the debt service coverage ratios which are under pressure in a higher interest rate environment.

Looking at some of the key market trends, inflation has been on everybody's lips in the past 12 months, and it is the key macroeconomic indicator that we are monitoring these days.

We saw 2022 which was -- which experienced dramatically inflation, primarily driven by the increase in electricity and energy crisis in general. That has completely been left out now of the headline information drivers. It contributes only by a very small margin, and we anticipate that it will actually contribute negatively in the coming quarters.

What is on the other hand becoming more and more sticky is the more service-driven inflation and we're also seeing that food prices is continuing an uptick although albeit stabilizing in recent levels at quite -- in recent months at quite high levels.

This inflation is something that we also see on the wage pressure that is fading through across the countries where to operate which is making it more and more difficult for the central bank to actually navigate the inflation, i.e., we don't believe that they will stop tightening in the immediate short-term, but it also means that the purchasing power of our tenants is becoming better and better.

We still believe that we will see a softening also in the core inflation over the course of the second half of 2023. We believe that the tightening that has been made by the central banks will evidently be fed through into the real economy.

If you look at the most recent interest rate development, there has been what we consider a stabilization for the past six months. No doubt that it has been associated with a higher volatility than we would normally see within such a given period but in general, we have seen the 10-year interest rate curve fluctuate within about 40 to 50 basis point interval, which is fairly narrow compared to the 300-basis point increase that we've seen over the past of the past 12 months.

We also think that there is more and more alignment between the increase in the nominal interest rate and how the inflation expectations develop. That means that the real interest rate implied by the nominal interest rate swap rates and the inflation swaps price in the market has stabilized in the last three months in particular.

We believe that the current real rate which is positive of around 50 basis points is sufficient in order to slow down the economy enough in order to cope with the increased inflation that we have seen recently and also get the core inflation down to a level in line with the central bank expectations albeit we also recognize that this might take longer than expected six months ago.

Now, I hand it back to the operator. Thank you.

Questions And Answers

Operator

(Operator Instructions). And our first question is from the line of (inaudible) from Barclays. Your line will now be unmuted.

Q - Unidentified Participant

Thank you for taking my question.

So, my first question is, how do you plan to bring down the leverage within your financial policy or could we see some weakness in the financial policy?

Also, does breaching financial policy have any implications regarding your dividend payments, et cetera?

I have follow-up questions as well which I probably can ask later on.

Hello?

Hello. Am I audible?

Operator

Speakers, are you there?

Q - Unidentified Participant

Yes. Am I audible?

Operator

Yes. You are.

Q - Unidentified Participant

Shall I repeat my question? Hello? Shall I repeat my question?

Operator

I think we have a small problem from the line of the speakers. Just hang on for a moment.

A - Helge Krogsbol {BIO 22570841 <GO>}

Hi, can you hear me now?

Okay.

Q - Unidentified Participant

Yes. I can. Yes. Shall I repeat my question?

A - Christian Fladeland {BIO 21623938 <GO>}

Apologize for that. I think I was speaking to myself when we found out there was no (technical difficulty).

Q - Unidentified Participant

Yes, no, is it all good now?

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A - Christian Fladeland {BIO 21623938 <GO>}

If you hear me, then it's all good.

Q - Unidentified Participant

Yes. I'll repeat my question.

So, my question is how do you plan to bring the new leverage within your financial policy or could we see some weakness in the financial policy?

Also, does breaching the financial policy has any implication regarding your dividend payments, et cetera?

A - Christian Fladeland {BIO 21623938 <GO>}

We are currently reviewing the financial policy and together with our Board in order to reflect the new environment. The baseline is that we want to align our financial policy with our rating ambitions. The basis of that is to maintain a strong investment grade rating.

Following the revised threshold by S&P back in December 2022, reducing the ICR threshold to 1.8 equal to or higher than 1.8 and a net depth to cap below 60%, we still have quite some headroom within that, but now, we need to evaluate together with the Board where we should accommodate that for the new environment.

There is no doubt that we don't intend to increase leverage based on acquisitions, et cetera, but given that we have seen a value decline of 9% in the last three quarters, there are, of course, circumstances which we need to address either through a revised financial policy to a new environment or how we can potentially seek a lower leverage over time.

In relation to the dividend payments, we have a clear restriction that we will not do any dividends that are not compliant with the financial policy. So based on the current financial policy and the thresholds there, there will not be any dividends.

Q - Unidentified Participant

Thank you. That's helpful. My second question is that it's sort of encouraging to see the continuous equity support. I would like to understand if you're being asked to sort of raise equity and material discounts given where many of your listed peers are trading.

A - Christian Fladeland {BIO 21623938 <GO>}

In general, we have a very clear principle that, we don't want to do any issuances at discounts. We have a clear shell that we missed stating that all issuances should be done at NAV.

Of course, when you are in the current environment where there is a lot of uncertainty about where values are going and you also see a listed space which have complete

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different characteristics but still setting some kind of baseline, it is of course impacting the pace of capital raising.

That being said, and we also see that we have a lot of hidden values on our balance sheet given that we have secured very attractive financing in previous years which has an implied discount to our NAV.

So, if you look at the fair market value of our debt, it's plus SEK20 billion lower than there was actually in our books, so you get a positive leverage effect from that.

We are definitely looking at how we can also utilize that market to do additional buybacks as we've done in the past 12 months and how that could potentially be a contributing factor in order to support the company without issuing at a diluted NAV to the shareholders while still capturing a discount in the market.

Q - Unidentified Participant

That's helpful. Thank you. And my third question is regarding hybrid, I understand you have time before your first call, but if you could provide me color on how exactly you're thinking about potential call or non-call decision?

A - Christian Fladeland {BIO 21623938 <GO>}

So we are very committed to the hybrid in our cap stack.

We have done some buyback, as you have seen in the past year, because we felt that replacing it with equity as a permanent -- as a NAV permanent equity instrument was quite attractive.

So, when we get closer to the call date, we will, of course, make an evaluation on whether we should go out and refinance or whether we should replace it with another equity instrument.

But we see hybrids as a fin and part of our capital structure, and we will evaluate when we get closer to the call date.

Q - Unidentified Participant

All right. That's helpful. Thank you very much for taking my questions.

A - Christian Fladeland {BIO 21623938 <GO>}

You're welcome.

Sorry for the technical issues.

Q - Unidentified Participant

No worries.

Operator

(Operator Instructions).

A - Christian Fladeland {BIO 21623938 <GO>}

We received a question whether we could elaborate around the rent negotiation and whether the like-for-like rental growth in Q1 2023 fully incorporate the negotiation result.

So, I assume that this mainly relates to Sweden which is only by the way we negotiate rents.

We have had some of our municipalities among us Malmö where there was 5% increase as of 1st of January but, in general, there was outstanding quite a significant number of municipalities.

So, we will see the full impact only during the first half of 2023 with several being only implemented as of 1st of April. So there are still outstanding results.

Across our other markets, there are quite a lot of countries where we have a 1st of January traditional indexation but we also have markets where rents are indexed on a running 12-month basis after they are initiated.

We also have markets where there's a 1st of July indexation like the regulated housing in the Netherlands, so it is varying, and you cannot assume from the Q1 like-for-like growth that the full indexation from 2022 is reflected herein. That will only feed in over the course of the year.

Do we have another call question?

Operator

We have no question from the phone right now. So, if you have any written questions, you can go ahead.

A - Christian Fladeland {BIO 21623938 <GO>}

Yes.

We also have another question say whether we have any plans for asset sales and whether we can elaborate a bit more broadly on the transaction market and the liquidity.

So in general, we do have a pocket of assets where we see that they are long-term non-call for us. It's not something that is urgent to sell. It's still within residential usage. We operate them well and efficiently, but it is something where we could see that we could redeploy the capital more efficiently elsewhere.

On the other hand, we don't want to do it in a market where we see such significant bid-ask spread and which is not well functioning so we don't have any stress to do it, but we will evaluate it on opportunistic basis.

We are continuously doing smaller transactions, so we also did one larger in Q1 this year where we sold a NOK1.4 billion portfolio in Oslo as part of our new development -- a development of a new hospital so it was either exploration process or negotiation.

So, we will continue to see how we can do accretive divestments, but we don't want to do anything aggressively in a market where we see such low liquidity and such significant bid-ask spread.

That leads to the follow-up question on that how do we see the transaction market in general.

We see that there has been a significant reduction in transaction volumes mainly driven by very cautious buyers but also sellers who don't find it appealing to divest at current pricing looking at their own prospects for future rental growth, increasing construction cost, increased supply-demand imbalances within residential.

So, there is clearly a divergence still between buyers and sellers. Albeit we do see -- we do start to see some individual transactions showing up very much driven by pure equity buyers either family offices or large institutions, sovereign wealth funds who want to increase their real asset exposure in an environment where we are facing increased uncertainty of long-term inflation.

We got a follow-up question. What we mean by reconsider our financial policy and whether that means that we are inclined to that LTV go higher for a while.

So, the LTV has gone higher due to the value of all we have seen in the recent quarters. We are aligning our financial policy with our rating ambition and the rating thresholds has been increased in December 2022. So, we don't have a strategic target to increase our LTV in order to create flexibility for growth or anything.

On the other hand, we also want to make sure that we are transparent and prudent, and also reflect in our financial policy how the current market situation is, both in relation to the increasing interest rates which like gravity will pull down our ICR.

We have had an exceptionally high ICR in recent years with close to 0% interest rate. If we go back to 2019, we had our ICR threshold in our own financial policy of about 1.5. So, I don't think that there is anything strange enough re-evaluating that given the new environment.

In light on margins on secure debt and provide some color on the depth of the secured debt market.

We have now been taking out SEK25 billion of secured debt during 2022, another SEK12 billion during Q1 2023, and we still see that there is very good access to bank financing also in the last six weeks following uh the Credit Suisse event here in Europe and the banking turbulence in the U.S.

There is probably no doubt that we've seen some market that market that margin pressure is prevailing. It's not anything dramatically.

We probably will see that banks are much more selective in the asset quality that they want to fund, and they also put restrictions on what LTV that they can fund with that.

So as an example, in order to have a debt service coverage ratio in a higher rate environment that satisfy the bank's credit requirements, you might now get 40% instead of 52%.

If you then have a similar margin or 10 or 20 bases for an increase, we see that as a tightening condition from a margin perspective but it's not dramatic.

We got a question on whether we could talk us through how we're going to handle the upcoming debt maturities in 2023 and 2024 versus our current liquidity cash and facilities.

Following the buyback that we had -- we carried out in March of SEK10 billion, we have reduced our 2023 maturities to SEK7 billion which we have available both in accessible facilities but also with cash at hand.

In relation to 2024, we are still working intensively in order to pre-fund most of that during Q2 and Q3 this year where we have term sheets and quite advanced discussion on the waste majority of that amount.

As I alluded to in the presentation, we are doing quite a lot in order to de-risk any refinancing even in the second half of 2024 by securing commitments from banks already now even though it comes at the expense of replacing cheaper debt with more expensive debt earlier on.

We find that's the prudent way to do and that's also going to hurt our ICR in the short run.

We got follow-up questions in relation to hybrid and whether extend the hybrids within management's consideration.

And, well, in terms of possible revision of financial policy whether you would like to stick to the S&P rating criteria or you might think about deviating from that?

We will definitely focus on our financial policy update on our investment rating grade ambition but, of course, we will not do it only based on the S&P criteria. We need to also evaluate what we believe is prudent in a new environment.

We feel very comfortable about the revised threshold from S&P that we'll be able to cope well with the LTV threshold within this group will be flat rating. However, due to the nature of the mathematics of an ICR and given that we want to pre-fund, we need to be more detailed on whether we are fully comfortable where the ICR might go in the short to midterm given to also focus on refinancing well in advance. So, it will be the income but I cannot say anything whether it will be a true replication.

FINAL

We also got a question where we are doing scenario analysis of main rating metrics ICR LTV.

If yes, what are the outputs?

It addresses whether the 2.5 ICR leaves little headroom going down to 1.8. It actually refers a bit back to my comment on the financial policy considerations. Yes. We do run these scenario analysis and there is no doubt that the ICR is a very tricky one.

Even though we also said that we see the interest rate curve has stabilized some in the last six months varying within a 40 to 50 basis point interval, on a percentage basis, it's actually a quite large interval and that can have significant impact on where we see the ICR exactly ending up.

We definitely see that we will get close to 1.8 whether we will be slightly above, at it or slightly below depending on how much with free from the current market in order to address refinancing is something we need to revisit a part of the financial policy.

But we do run these scenario analysis and we also are very humble about the sensitivity hereof.

We got a question whether we think the increase in secured LTV will impact your access to unsecured bond market.

We had significant headroom looking at six to nine months back in relation to our secured LTV before we consider this would be any negative impact on our access to unsecured bonds.

We are now starting to increase it quite rapidly and we also see that when we are to handle our 2024 maturities with secured debt, we will also end up at or very close to the 30% secured LTV threshold.

So, at some point if we are going into 2025 and we still see that there's not any well-functioning bond market where we should probably need to trade off how we want to navigate that but for now, we don't see that there is any risk that it will compromise our access to the bond market.

We got our questions whether we had discussions for further equity raises.

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We are continuously seeking equity in order to develop and strengthen the company. We've been growing for several years, and our ambition is also to continue to do that on the other side when we have more visibility and also feel that we have sufficient capacity within our balance sheet. So, we have a dedicated capital raising team.

We got in a new investor in Q1 Greater Manchester Pension Fund. We've seen continued commitment from our existing shareholders reinvesting their dividends. So, we are definitely in ongoing discussions always to raise equity.

We got a question whether we are planning to tap the bond market for refinancing any overall 2024 maturities or we are mainly -- mostly planning to revise refinance that through secured financing.

I can say very clear that our base case scenario is that we will not go into the bond market before 2025 the earliest. That's the plan that we navigate according to.

We hope that there will be an opening to do it as we believe that it's important to get an opening of the bond market and we also want to maintain a diversified funding base.

But given how the volatility has been in the past 12 months and the lack of visibility on when it will open, we feel it would not be prudent to be dependent on it so it's not a part of our base case.

Okay.

We got a question, what is the unencumbered asset versus unsecured debt ratio now?

So, we don't publish the unencumbered ratio, but we have a secured LTV that we published, and we stand at 26.6% of Q1 2023 up from 22.6% in Q4 2022.

Would you consider calling hybrids even if the reset was below the market rate for a new hybrid issuance?

We are very focused on maintaining our strong capital market reputation so this will definitely be something that we will evaluate when we get to that point in time but it's not something that we're able to comment on in detail almost two years before the first probably.

As I understand, there are not any more questions.

So based on that, I want to thank everybody for listening in.

We are always available to take direct inquiries through our investment -- investor relations.

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