This is a translation of an article published in Swedish. All quotes are translated.

Real estate financing is dominated by bank lending but the real estate companies should reflect on their diversification of funding sources. This topic was discussed at Brunswick Real Estate seminar in Almedalen by (from left) Tomas Ernhagen, Chief Economist Fastighetsägarna, Svante Andreen, Partner Brunswick Real Estate, Lars Ericson, Chairman of Folksam Liv and CEO Konsumentföreningen Stockholm, Eva Landén, CEO of Corem and Chairman of Specialfastigheter, Lennart Sten , CEO of Svenska Handelsfastigheter and Chairman of Fastighetsägarna, Samir Taha, co-founder and board member of Aros Bostad

How can institutional capital contribute to a sustainable financing market, meeting the long-term needs of Commerical Real Estate

After years of low interest rates and uncertain economic future, real estate companies need to reflect on the diversification of funding sources. This, and property financing in general was discussed at Brunswick Real Estate's well-attended seminar in Almedalen July 3, 2018. The panel consisted of Svante Andreen, Partner Brunswick Real Estate, Eva Landén, CEO of Corem and Chairman of Specialfastigheter, Samir Taha, Co-Founder and Director of Aros Bostad, Lars Ericson, Chairman of Folksam Liv and CEO of Konsumentföreningen Stockholm and Lennart Sten, CEO of Svenska Handelsfastigheter and Chairman of the Swedish Property Owners Association (Sw. Fastighetsägarna). The discussion was moderated by Tomas Ernhagen, Chief Economist of the Swedish Property Owners Association.

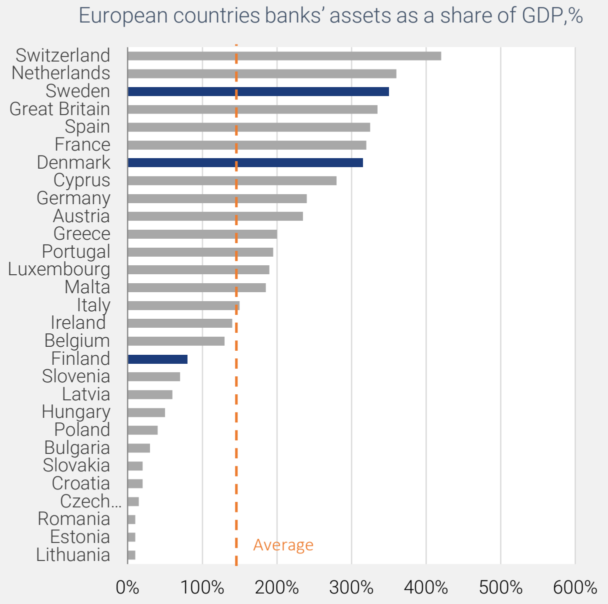
Risk of Less Robust Bank Lending?

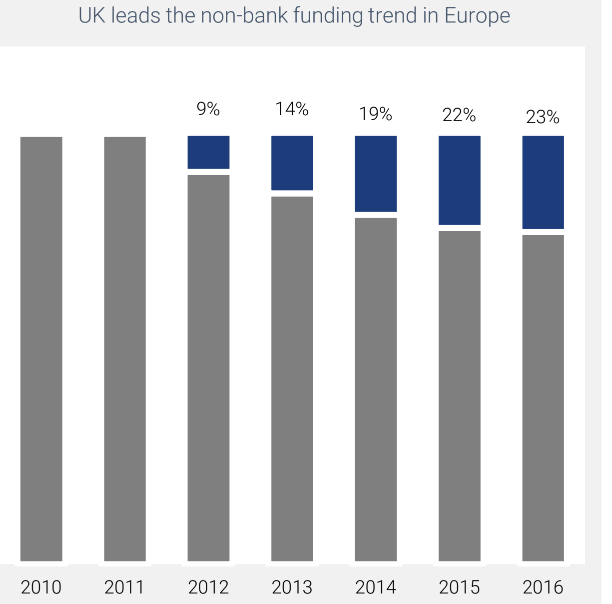
Real estate investors have traditionally turned to the banking system for capital. In recent years, banks have lent abundantly to real estate, as it has been a convenient asset class for banks to deploy capital. However, the size of the Nordic banks make them sensitive to economic cycles, as their lending is considerable, especially when compared to their international counterparts. In a situation of an economic downturn, the question is whether the Nordic banks will be able to handle the refinancing needs that continuously arise.

- The real estate companies which have had access to the capital market have had a phenomenally favorable situation in recent years and have been able to borrow at 60-80 points, even in their long-term funding. The question is how robust is bank lending in an economic downturn?

This rhetorical question was posed by Svante Andreen, a partner at Brunswick Real Estate, who went on to describe the challenges that real estate companies face in matching their capital requirements against their long-term assets.

- Real estate is a very long-term asset class. During a property's life, it will have to be refinanced several times. At times, real estate has faced poor liquidity. To face refinancing in a liquidity crunch can quickly lead to trouble. This certainly illustrates the difference between being solid and being liquid. From an asset-liability perspective on the real estate side, there are good reasons to consider having a share of long-term funding and to evaluate how diverse the funding sources are.





Source: Riksbanken, Finansinspektionen, European Systemic Risk Board

- The largest proportion of real estate financing today is quite short-term, up to three years. That is our niche at Brunswick Real Estate Capital. We offer very long-term financing, currently up to ten years, and are therefore, by definition, a diversification alternative with regards to the banks. We see ourselves as a complement to the banks, not a competitor.

Tough Financing Market for Housing Developers

Tomas Enhagen, Chief Economist at Fastighetsägarna the moderator of the discussion stated that financing needs are large moving forward.

- According to Boverket's [National Board of Housing, Building and Planning] forecast, funding needs range in 210-270 billion per year just for housing. That is a huge amount to be financed. And in a potentially messy market going forward.

Residential Property Developers is the segment of the real estate industry most affected so far. Samir Taha, Co-Founder and Director of Aros Bostad, characterized the financing market as closed.

- A 15-20 percent price increase per annum is not healthy in the long run. A normalization and a slight rebound is expected and even desirable. But as usual, the pendulum is swinging over to one side or the other. Right now, put simply, one can say that the traditional banks have tightend lending toward the average consumer. For a number of years, measures were introduced to limit price increases; mortgage cap, amortization requirements and now the debt to income cap. This coincided with a substantial supply increase. Therefore, the traditional banking market created a significant tightening which should not have been necessary.

He emphasized that he considers the Swedish financing market underdeveloped compared to the Anglo-Saxon market.

- It's pretty digital, either you get a construction loan and acquisition credit at 200 basis points or you get nothing. There is no in-between. There are few other options, such as channeling institutional capital.

Samir Taha explained that he hardly envisions that the institutions have the capability to take on the role as direct lenders to the real estate sector.

- The institutions are very streamlined so they can not assess credit risk or administer that kind of investment. There is a gap in the financing market to provide risk-adjusted financing for all types of real estate investment. We now see emerging Anglo-Saxon actors and German funds that are a step ahead that enter Sweden through advisers. My hope is that permanent alternatives to banks will be established, said Samir Taha.

Svante Andreen described Brunswick's offer and compared it to the option that the institutions face in bond investments.

- For institutions we offer that, instead of the 80 basis points in return that they can get when investing in bonds, we can offer a couple of hundred basis points. That poses the question whether there is a liquidity premium or not? We do not think so, because even investment grade bonds in some form of distress or comparable volumes are not very liquid. So the difference in liquidity is not particularly large. We simply believe that there is an anomaly in the market and that there is great growth potential for this type of direct lending. What we do is that we channel the long-term commitments of the pension funds, which can absorb long liquidity risks, directly to the property side with long-term needs, said Svante Andreen.

Limited Opportunities for Long-Term Financing

Tomas Ernhagen asked members in the panel in other real estate segments than housing if they experienced the tougher financing landscape that Samir Taha described.

Eva Landen, Corem CEO and Chairman of Specialfastigheter was unaware of any such effect on the funding in their segment; warehouse and logistics.

- Rather, it has become a bit easier for us to find financing, but it shifts. When Corem was formed ten years ago, no-one dared to lend to warehouse and logistics and we had only one bank. Since then, we have worked on spreading the risk and now we work with both Brunswick as well as bonds. As it gets tougher on the residential side, we can borrow more of classic real estate loans from banks, although, we want to differentiate ourselves. However, we have been unable to secure long-term loans, we seldom receive tenders for more than three years, said Eva Landen.

Lennart Sten, founder of Svenska Handelsfastigheter and Chairman of Fastighetsägarna has not experienced the housing sector's harsher financing markets spread to the commercial property segment. He feels, however, that banks in general have become more cautious toward real estate, which he believes can be a healthy caution. It has, however, created barriers to entry for new players. Lennart Sten agreed about the difficulty of obtaining long-term capital.

- What has happened since the Lehman crash is that it is very difficult to get long-term capital commitments from banks. You can obtain longer interest rate commitments in today's market than you could 15 years ago. But capital commitments basically cap at three years. It may be possible to obtain five years it but it is much more expensive. I think that is contradictory for long-term real estate investment. It's certainly a problem. If given the choice to swap interest commitments for capital commitments, I would take that any day of the week and gladly pay for it, said Lennart Sten and provided his view of the risk of short-term capital.

- We've enjoyed a boom in the economy over the last couple of years and interest rates have not gone up. Interest rate risk is therefore manageable. When the downturn comes, rates will not rise, but it will become difficult to gain access to capital altogether. If I could, I would love to have 30 year maturity on capital, if I could get seven years, that would be fantastic.

Svante Andreen expounded his views on why the banks are so restrictive with long-term capital.

- The banks are only following regulations. The Basel III rules forces the banks into short-term lending. Traditionally, banking profits from funding short-term and lending long-term and making money on the spread. It has gone awry a few times in recent years, so the authorities, with good reason, try to prevent it from happening again. So they force the banks to match the duration their of financing and lending. As Swedish banks are exceptionally large issuers of bonds, among the world's largest, an extension of the duration of their funding side is very costly and would immediately hit profitability. So the only way to handle it is to go short-term on the asset side. Additionally, there are some specific rules that contribute to making maturities of around three years and up more expensive. So banks can not lend longer-term, despite wanting to, as it is in their interest.

He also stressed that the banking system and asset holding companies have become much more sensitive to economic fluctuations under IFRS and Basel III rules. The question is whether the banks really will make the real etate companies insolvent the day they need to renew their loans and there is a recession. Lennart Sten believes the banks would do everything to avoid it as it would prove too costly for the bank itself. Instead, he believes that the banks will likely hike up interest rates and reap the lion's share of the cash flows.

Lars Ericson, Chairman of Folksam Liv and CEO of Konsumentföreningen Stockholm stressed that banks value their long-term customer relationships and will not sacrifice them easily.

- There are not many of the big banks that would surrender a long term customer relationship, particularly if it is a stable relationship. However, when it comes to newer entrants, they are more cautious. Especially shoud new entrants to the housing market appear, said Lars Ericson.

Samir Taha, Co-Founder and Director of Aros Bostad, presented a very tough financing market for housing developers.

Svante Andreen, in contrast, pointed to the experience of the 90's. He insisted that when the economy is in a downturn, the capital in banking system will not suffice. Real estate companies will suddenly suffer unrealized losses which will hit the solvency of the companies, which is still an important measure in the banking system. The lesson from the 90s is that the banks then are forced to prioritize among their customers.

- So if you are an asset owning company in a situation where the economy might indicate a bit downward, I would do anything to get longer-term capital commitment, said Svante Andreen.

Opportunities for Institutions

Lennart Sten pointed out that a larger problem in general for the banking system is a lack of ability to price risk rationally. Over the past ten years, there has been a binary situation in Sweden that either you may borrow capital or you get nothing. Lennart Sten felt that earlier there was a broader range of capital where different creditscores created the opportunity to borrow cheaper or more expensively. Samir Taha, Aros Bostad agreed.

- For us residential developers, there are no options. Simultaneously, the institutions chase returns but can not administer credit rating, monitoring, or manage receipts and payments.

Thus, Lennart Sten saw a perfect match with the long-term approach of the institutions.

- It would be great for pension funds to get a fixed return of 25 years that match their commitments. If able to find good assets with the right level of leverage, it would suit every measure they abide. But the market has not really materialised yet. They seek long-term lending operations, and there are people like me who are looking for long-term loans. But it does not match yet.

Tomas Ernhagen asked the question if the risk in the real estate industry should increase with longer-term loans, with Lars Ericson at Folksam Life emphasized that for an institution compared the risk of the investment options available.

- The risk in the real estate market has always been analyzed and compared with other risks such as the equity market risk and bond market risk. If you look at a five to ten years timeframe then it is the bond that is the option for an investor. And compare it with, for example, Brunswick's offer, it's 170 points difference in return. If you feel confident that your investment manager has a sufficient analytical capacity, credit management capability and are sufficiently careful in their assessments then it is a much better option if you want to diversify your portfolio.

Lars Ericson pointed out that in Folksam's case, it's about 0.75 percent of total assets allocated toward direct lending to real estate.

Downturns in the market are as inevitable as economic fluctuations. Lennart Sten argued that a risk of thirty years actually is lower than seven years.

- The biggest risk for loans is really at six to seven years. It is impossible to predict seven years ahead, but you can produce a pretty accurate estimate for three years. Take the real estate market – What is the risk over 20 years, viewed historically? There is almost no risk. If you have a sufficiently long loan at a reasonable loan to value around 50-55 percent, I would say that the risk is much lower than compared to five years.

Closing off, Svante Andreen, in view of banks tightening housing developers credits, commented on the ability of banks to price more mezzanine-like risk. He argued that operationally it is foreign from the bank's core business as it requires other personnel.

- A bank lends money expecting it back. Everything that is below investment grade, or above 60 percent loan to value requires a completely different business model. I therefore believe that it is better suited outside the banking system. Even from an economics perspective, taking the taxpayer's view.

He concluded by stating that he envisions a substantial increase of alternative to bank financing in the future.

- The need is there but it will not be provided by banks, but by players like us. Europe and Scandinavia in particular have a large banking system relative to its economies. In the US, the situation is different with more of this type of solution provided by funds or the capital markets already. I predict that we will see that development here too. If it is we at Brunswick or another player offering these thirty-year maturities, we will see. Regardless, I think that financing options outside of the banking system are bound to emerge.