

Rating Action: Moody's assigns Baa3 rating to Sato Oyj; stable outlook

Global Credit Research - 20 May 2015

First-time rating

London, 20 May 2015 -- Moody's Investors Service has today assigned a first-time long-term issuer rating of Baa3 to Finnish private residential real estate investment, management and development company, Sato Oyj. The outlook is stable.

"We have assigned a Baa3 rating to Sato to reflect its prudent management of a high quality residential property portfolio. This portfolio generates steady cash flows that underpin it's a liquidity profile that is commensurate for the rating," says Lynn Valkenaar, a Moody's Vice President-Senior Analyst, and lead analyst for the issuer.

RATINGS RATIONALE

Today's rating assignment primarily reflects Sato's effective management of its high quality, well-located residential property portfolio. The portfolio's granular tenant base and consistently high occupancy rates (i.e., 96.4 % at 31 March 2015) produces steady cash flows.

Sato is a large player in the Finnish rented residential property sector and has developed meaningful franchise value, which enhances its ability to attract tenants in a dynamic and competitive rental market. The company's real estate is located in five Finnish cities, with a concentration, by value, of around 80% in metropolitan Helsinki. These cities are growing, have diverse industrial and service sector bases, and comprise the vast majority of the nation's population. Around 4% of Sato's portfolio by value is located in Saint Petersburg, Russia's second-largest city.

Sato's original business was the development of their housing land and the company continues to develop homes through third-party contractors. However, its strategy changed in 2009 and it began to retain its own apartments such that its core business is now the leasing of residential investment properties.

Although property development activity raises the company's business risk profile compared to other property investment companies, management are careful to limit and control its exposure to construction risk. Sato's committed development pipeline, including work-in-progress, is not large and has historically represented less than 3% of total assets.

Planning consent in Finland requires that a housing development contains a mix of apartment sizes and while Sato retains the smaller size units, for which rental demand is the greatest, it sells the larger ones to owner-occupiers. Looking forward, Moody's expects that Sato's management will sustain its strong rental performance while continuing to grow organically through its development programme.

The residential rental market in Finland is more fluid than other European countries. Sato's average tenant stay is around three years, which Moody's believes is reflective of the Finnish market as a whole but is short compared with some European countries such as Germany where average tenancies last 12 years. Competition in the residential rental market in Finland is becoming increasingly sophisticated. However, Sato has developed its franchise value as a large residential landlord in Finland with a recognized brand name.

Three population trends in Finland underpin demand for rental housing in general and Sato's rental housing stock in particular: urbanisation, an increase in immigration, and the growing proportion of one-person households. Sato's rental apartments meet the deepest segment of tenant demand as they lie at the smaller end of the range and average 57 square metres (sqm), which is an adequate size for one- and two-person households.

Sato's financial strength metrics are adequate for its rating level. As of 31 March 2015, "effective leverage" (defined as adjusted total debt/total assets) was fairly high for a Baa3 rating at 57.8%. Effective leverage has declined over the past two years, owing to an uplift in asset values and a moderate dividend policy, a trend Moody's expects will continue. However, year-to-date fixed charge coverage (defined as EBITDA/gross interest expense + capitalized interest + ground rents) was strong at 3.3x and, looking forward, the rating agency expects this financial metric to remain strong, at around this level.

Moody's believes Sato's Baa3 rating can accommodate somewhat higher initial leverage owing to its robust fixed charge coverage and because its residential property portfolio has historically shown itself to be a fairly stable asset class with respect to income and values. However, unlike its rated German residential property company peers, Sato is exposed to higher business risk owing to a much higher tenant churn, an exposure to development risk, and a greater level of competition from an ongoing increase in the supply of new rental housing.

Sato exhibits an adequate liquidity profile, which is underpinned by stable, recurring cash flows. Its debt amortisation profile is staggered with no significant debt maturities in any one year, with amounts of less than EUR250 million. However, the company's various revolving credit facilities contain material adverse change clauses. Sato's secured bonds have minimum collateralisation covenants and collateral levels are actively managed to remain in compliance.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook for the Baa3 rating incorporates Moody's assumption that the issuance of unsecured notes will replace secured bank debt, thereby increasing the pool of unencumbered assets to at least 35% by the end of the second quarter of 2016. Most of Sato's assets are encumbered because its debt is secured by its properties.

The stable outlook also reflects Sato's steady generation of rental income and a rental housing market in which demand for smaller sized units exceeds supply. The outlook also incorporates management's experience in maintaining high occupancy rates despite the fairly high tenant turnover. In addition, the rating agency expects that Sato will maintain an adequate liquidity profile at all times.

What Could Change the Rating -- Up/Down

Upward pressure on the rating or outlook could develop if effective leverage were to decrease to around 50% and fixed charge cover were to remain above 3.0x, both on a sustainable basis.

Conversely, downward pressure on the rating or outlook could result if (1) unencumbered assets/total assets were to fail to exceed 35% by the end of the second quarter of 2016; (2) effective leverage were to rise above 60% or fixed charge cover were to drop below 2.5x, both on a sustainable basis; or (3) the company were unable to maintain an adequate liquidity profile at all times.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Global Rating Methodology for REITs and Other Commercial Property Firms published in July 2010. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

Sato Oyj is a residential real estate investment, management and development company that was established in 1940 and is registered in Finland. Its strategy is to develop rather than acquire new housing stock and to sell units that appeal more to owner-occupiers than the rental market. The company is privately held; its shareholders are largely pension and life insurance companies. The company reported annual revenues of EUR 312 million and total assets of EUR2.8 billion as of 31 December (FY) 2014.

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