Strong investor demand for prime property, but the yield spread between prime and secondary locations will increase

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The market activity in December was rather strong with a transaction volume of SEK 23.5 billion, which can be compared to SEK 28.7 billion in December 2017. In January the market activity was really strong and volumes ended up at SEK 12.2 billion, compared with SEK 4.7 billion in January 2018. The full-year transaction volume ended up at SEK 133 billion in 2018 (SEK 155 billion including indirect acquisitions*). This can be compared with a full year volume of SEK 147 billion in 2017 (SEK 148.5 billion including indirect transactions).

The largest two transactions during January were when Lilium bought a mix (mainly commercial) portfolio in Sundsvall from Castellum, while Castellum acquired a portfolio in Linköping from Lilium. All in all, the transactions amounted to SEK 5.2 billion. The third largest deal in January was Allianz and CBRE Global Investment Partners' acquisition of a warehouse leased by Volvo from Söderport and Ness, Risan & Partners for around SEK 1.5 billion. In addition Barings acquired through forward funding a major residential project including 600 apartments in Stockholm from Slättö and Fastpartner for around SEK 1.3 billion.

The Swedish listed property companies have increased their net-acquisitions in 2018. An important reason for this is their strong performance on the stock market as well as their access to extremely affordable debt financing (at least up until November 2018). However, these companies are highly cyclical in their transaction activity. Companies with low risk in their business model (and continuous access to cheap credit) will likely keep on buying, while companies with higher risk will be hampered by higher interest rate margins in 2019–2020. Swedish pension funds have reduced their net investments during the last 12–18 months. They have in particular been selling off office assets in Stockholm. They are instead focusing on older residential properties and public properties. Based on inflow into the pension system (and stable market conditions) the Swedish institutions need to net-invest around SEK 10 billion per year on the property market during coming years.

International funds are driving demand for prime offices and foreign core investors such as Allianz, Barings, Deutsche Bank and Union have all acquired office properties in Stockholm in the past 12 months. These actors have considerable purchase power and a positive view of the rental market, and have entered the space that was created when Swedish institutions started to sell. The office market in larger cities is currently at its peak, but some (mainly domestic) investors start to expect slower rental growth. Foreign investors have increased their investment activity lately and represent around 14 per cent of all investments on the Swedish property market in 2018. Foreign investors (funds) are now net-investing in Sweden for the first time since 2008. Although there are both core and opportunistic funds hoovering the market looking for opportunities, foreign investors have gradually been downscaling their aggregated net-investments since the second half of 2018. When it comes to the market for newly built residential homes investors are ready to pay up for properties in good locations in Stockholm and the major cities, while they have become increasingly selective regarding non-prime locations over the last 12–18 months. As a result yield spreads between prime and secondary locations have increased. There is a continuously strong demand for old rental homes (where there is a potential to increase rents), but over the last 6–12 months it has become more challenging to sell properties in smaller cities where the demographical development is expected to be weak over time.

Average yields for office transactions have fallen to historically low 4.5 per cent. Over time, the average yield development tends to move in line with transaction volumes (where higher volumes means lower yields). In 2018, however, transaction volumes have fallen back significantly while average yields have declined. This is due to a larger focus in transaction activity to the prime end of the market in the major cities.

Average yields for retail transactions have started to increase slightly since late-2018. It has been increasingly challenging to sell shopping centres and retail warehouses over the last two years. There is a strong investor interest for prime properties, while properties in secondary locations/smaller cities are getting increasingly hard to sell. Yields for properties in secondary locations have increased during the last years but there are rather few deals done as not many property owners are willing to sell below current book value. A number of high-yielding deals in non-prime locations have, however, been made over the last quarter, which has started to pull up average yields.

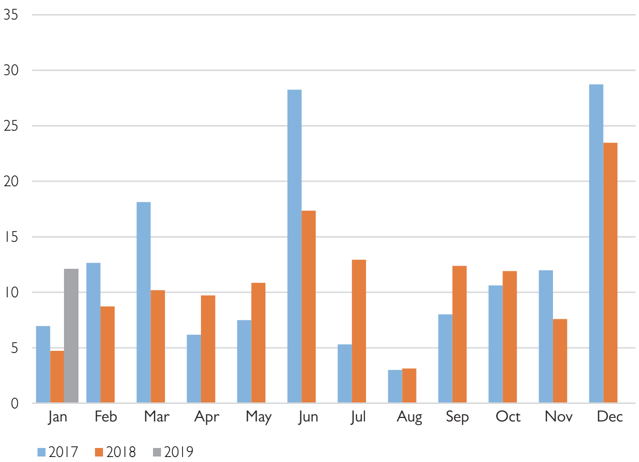
The global stock and bond markets have been volatile since last autumn and the policy decisions of the main

* Indirect property transactions are defined as acquisitions of significant parts of listed property vehicles.

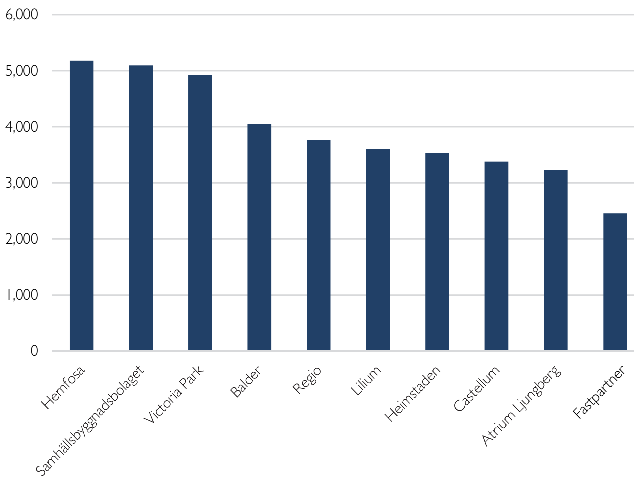
central banks will be essential for the development on the Swedish property market going forward. One of the main reasons to last year's stock market falls (and the increasing interest rate margins on the bond markets) was the global shift from QE to QT during the second half of 2018. Towards the end of last year the accumulated balance sheets of the major central banks (combined balance sheets of Fed, BoE, ECB, PBoC, BoJ and the Riksbank) started to shrink for the first time since the financial crisis – from an annual growth rate of around USD 3 trillion in mid-2018 to a decline of around USD 700 billion year-on-year in January. This decline in surplus money was one of the main reasons behind the recent decline on the global stock markets (other reasons where higher interest rates, the trade war, slowing global growth mainly due to the slowdown in China, Brexit, and the US government shutdown). Further on, one of the main reasons to the recovery on the markets in January has been investors' expectations of a more dovish Fed going forward (which also was clearly indicated by the Fed in its January statement). However, around 70 per cent of the US GDP is household consumption. US employment and wages are growing strongly and private consumption growth is picking up too (which leads to continuous GDP growth above potential and higher inflation). It is quite likely that the Fed will pause for a while and then pick up the gradual monetary tightening after the summer, which in that case will continue to drag global stock markets downwards.

The Swedish property market and the return on equity for the property companies have strongly benefitted from this flow of central bank liquidity. Property equities have had an extraordinary strong development during recent years due to growing NOIs, steadily declining interest rates and declining interest rate margins (especially for companies with higher risk in their business models). This environment is, however shifting going forward. Catella expects slower rental growth and slightly higher market interest rates and increasing interest rate margins from now on. The equity prices for the listed property companies have passed their cyclical peak and may end up in a long-term bear market with gradually lower highs and lows. However, the weaker economic growth will probably entail continued low real interest rates for an extended period of time, which creates a relatively high floor for prime property prices. ■

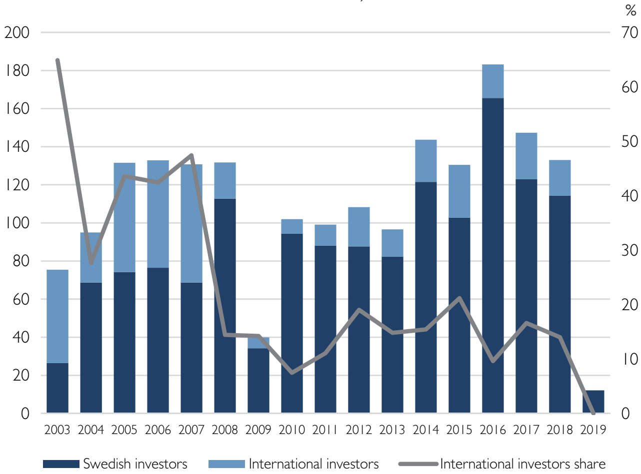
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION