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Low interest rates are pushing up prices and total return in the short term

– but high property values may create problems in the long term

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June was a relatively strong month on the transaction market and the volume ended up at around SEK 19.9 billion for the month. This can be compared to SEK 28.3 billion and 17.4 billion in 2017 and 2018 respectively.

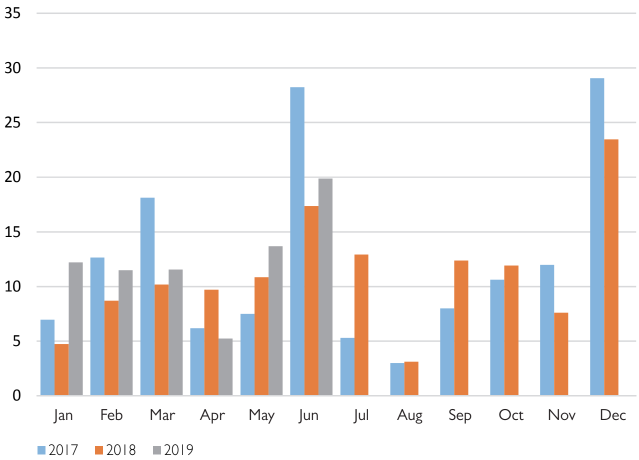
The first-half-year volume ended up at SEK 74 billion (compared to SEK 79,7 billion in 2017 and SEK 61.5 billion in 2018) and the rolling 12-month volume currently stand at around SEK 145.5 billion (up from the 2018 full-year volume of around SEK 133 billion excluding indirect transactions). The largest deal during June was Blackstone's acquisition of a 500,000 sq.m. logistics/industrial portfolio from Corem for SEK 4.2 billion (SEK 8,500/sq.m.). The portfolio includes 30 properties located in 13 regional/smaller cities. The second largest deal of the month was Nyfosa's acquisition of a commercial property portfolio from Klövern for SEK 1.6 billion. The portfolio includes 21 properties mainly located in regional cities and includes retail, office and mix commercial premises. Apart from that, Söderport bought two industrial/logistics portfolios located in the Stockholm region from Nyfosa and Sagax in two separate deals for a combined volume of SEK 1.4 billion.

The property sector has shown a strong performance during the first half of 2019. While the equity total return on Stockholm OMX 30 has been 19 per cent year-to-date, the average for the property companies on Stockholm Main Market was 30 per cent year-to-date. Over a three-year-period, the equity total return of listed property companies on Stockholm Main Market has been over 85 per cent in total. Stockholm OMX 30 has delivered a total return of less than half that figure (around 40 per cent) during the same period. Property companies with a logistics/industrial and residential focus have shown the best performance, with a total return of around 50 and 30 per cent year-to-date respectively. The premiums on the equity market have also increased lately and the listed property companies on Stockholm Main Market has currently an average premium on EPRA NAV of 11 per cent (compared to the long-term average of 3 per cent since 2010). The largest premiums are for companies focusing on the logistics/industrial, prime offices and residential properties. In contrast, companies focusing on retail properties and commercial properties (offices) in non-prime locations (non-prime locations in the major cities and all locations in smaller cities) are in general having discounts on the equity market. Over time, the equity market is a good leading indicator of the performance on the property market. There is a strong correlation between the equity market's valuation of the property companies' portfolios and the companies' book values around 18 months later. Property companies with premiums on the equity market also tend to have access to equity and debt capital, and these companies create instant value for their owners when they invest more within their prioritized property segments (through projects and acquisitions). This in turn creates market comparables for the valuations of their entire property portfolios, pushing up their book values.

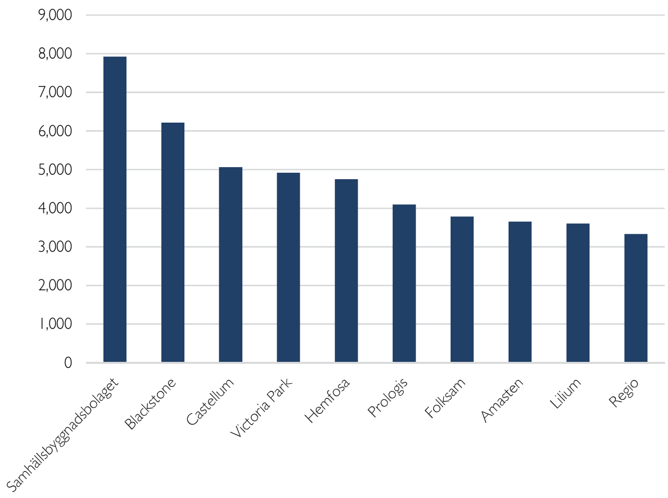
The Swedish economy is slowing down and the growth rate for the domestic side of the economy is virtually on standstill, with zero growth in both fixed capital formations and private consumption. The bond market also clearly indicates slower global growth going forward. The Swedish 10-year government bond yield where in negative territory until mid-June (now it is just above the zero mark) and Swedish and German 10-year bond yields have eclipsed their 2016 nadirs during the spring (the German 10-year bond yield are currently just below -0.30 per cent). One important gauge of the global economy is the yield difference between short and long-dated US government bonds. The yield difference between 3-month US government bills and the 10-year bond has gone significantly into negative territory since mid-May, and is now below -0.10. The yield difference between short and long-term bills/bonds has been a reliable indicator of every upcoming US economic recession since the late 1960s (around 18 months ahead). The message from the yield invention is that the bond market is expecting slower global growth and significant rate cuts from the Fed during the coming 12–18 months and thereby a more expansive monetary policy also for the ECB and Riksbanken. The cost of credit (market interest rates and interest rate spreads) is one of the main macro factors driving the property market and there is an almost perfect correlation between the listed property companies' average cost of financing and the reported yield levels of their property portfolios. Since the ten largest listed companies have a fixed interest term of around three years in average, changes in the underlying market interest rates and interest margins are rolling through the companies' average interest expenses slowly. During the five-year period since late 2013, the average interest expense for the ten largest listed Swedish property companies has declined from around 4.0 to 1.7 per cent. During the same period, the reported yield levels of their properties have declined from around 5.5 to 4.2 per cent. The average interest rate for the listed property companies increased somewhat between Q4 2018 and Q1 2019 (from 1.6 to 1.7 per cent), that was however mainly due to a combination of an increased STIBOR 3M rate (due to the repo rate increase in January) and an increasing average interest rate and debt maturity.

Total return on the property market will be strong in 2019 and gradually lower average financing costs for property investors will push out more capital on the property market, stimulate investors to build volume and to some extent push out investors on the risk scale to higher yielding property segments (where Blackstone's acquisition of a portfolio from Corem is a good example). Investors are, however, still selective and are mainly focusing on well-located commercial properties in the main cities and residential properties as well as logistics and public properties. The average interest rate costs of the Swedish property companies will likely continue to decline gradually during the coming 12–18 months, which will continue to push down prime property yields in the major and regional cities. In the long term, however, low yields and weak economic growth (which is what the bond market tell us in the long term) will hamper total return while high property values make the sector increasingly sensitive to structural shifts in tenant demand. ■

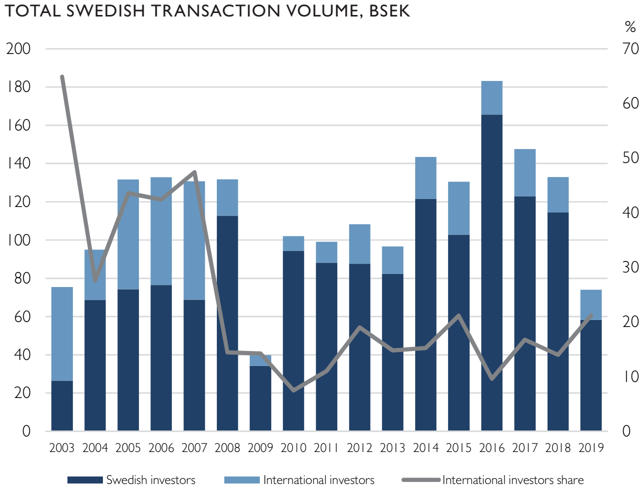
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION