CATELLA

A structural shift in the market for residential properties results in lower yields

In recent years, there has been a lot of activity on the residential market and property yields have decreased considerably. During the past six months, residential yields have fallen by approximately 50 basis points, in particular in regional and smaller cities.

So far this year, the transaction volume for residential properties amounts to over SEK 32 billion, equalling the transaction volume for the entire year of 2015. Institutions and listed property companies are dominating the market, with Willhem, Victoria Park, Balder, Slättö, Samhällsbyggnadsbolaget and SPP being the biggest actors and accounting for around half of the investment volume so far this year.

Over the past decade, significant changes have taken place in the market for residential properties. Traditionally, this market has had a regional focus where municipal companies and private – often local – actors have been the largest property owners. However, during the mid-2000s this situation began to change as investors with a wider, nationwide focus entered the market. Between 2005 and the financial crisis of 2008, Swedish private property companies such as Akelius, Heimstaden, Din Bostad, Wallenstam and Stena Fastigheter, as well as international private actors such as Acta, Property Group and Essex, accounted for the majority of investments. These companies alone represented approximately one third of the total residential investment volume during this period. In general, Swedish property companies concentrated on high-quality residential property in large and regional cities, while international investors generally were more financially driven and invested to a greater extent in properties in poor areas with higher property yields (even though they generally lacked the necessary property management skills).

Between January 2005 and August 2010, there was a positive correlation between transaction volume and the average property yield for residential properties. In other words, property yields went up when the transaction volume increased and went down when the transaction volume decreased, i.e. the opposite of the correlation for commercial property. The correlation coefficient was 0.79 between January 2007 and August 2010, which indicates a very strong positive correlation. The reason for this is that high-yield property in smaller cities and secondary locations in larger cities made up a significant share of the translation volume in the years leading up to the financial crisis. Property yields fell when the economic cycle turned in late-2008, as rental housing property had the character of a "safe haven". The stable rental market and low vacancies in large and regional cities attracted risk-averse investors to the residential segment once the macroeconomic turbulence hit.

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However, in the autumn of 2010 a new type of actor entered the market. First, a number of institutionally-owned property companies that focused on owning and managing residential property over the long term began investing in the market, and later on a number of listed property companies joined them. Since 2010, the largest investors have been Rikshem, Willhem, D. Carnegie, Victoria Park and Heimstaden/Nordhalla. Together, these investors account for over one third of the total residential investment volume since early-2010. Initially, these companies focused on large and regional cities, but as competition became tougher they moved increasingly towards smaller cities as well as further towards the northern parts of the Sweden. The companies have different business models that are aimed at everything from managing and developing residential property in poor areas, to new production or simply owning high-quality residential property in attractive locations. In recent years, we have also seen new listed actors such as Amasten that specialize in rental housing in smaller cities that are within commuting distance of regional cities.

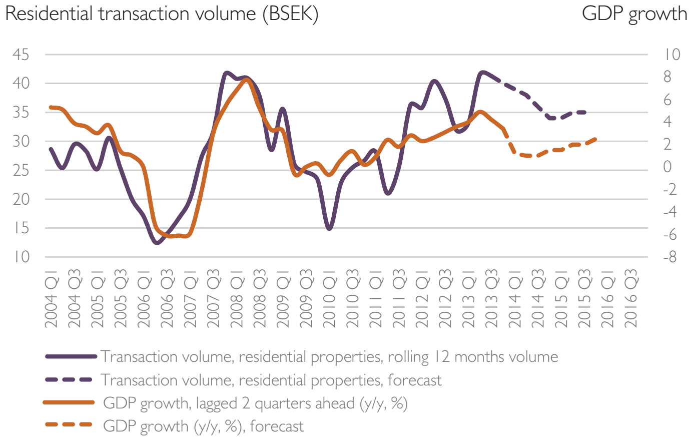
The new actors have created a clear shift in the market, and the correlation between transaction volumes and property yields reversed more or less overnight. Since the autumn of 2010, the market for residential property behaves in the same manner as the market for commercial property. In other words, property yields fall when the transaction volume increases and vice versa. Between September 2010 and October 2016, the correlation coefficient between transaction volume and property yields was –0.83, which indicates a very strong negative correlation.

So what does this tell us about the future development of the residential property market? The new actors have caused the market to behave in a similar manner as the market for commercial property. This means that property yields go down when the economy improves and go up when the economy is weakened. However, changes in property yields are smaller for residential property than for commercial property, as the market has stable rental income and is dominated by institutional long-term investors. In addition, there are many indications that the change in the market since 2010 is a structural shift and that the new investor base is here to stay. This, in turn, means that property yields in regional cities and smaller cities will not return to their historical average once the economy takes a turn for the worse.

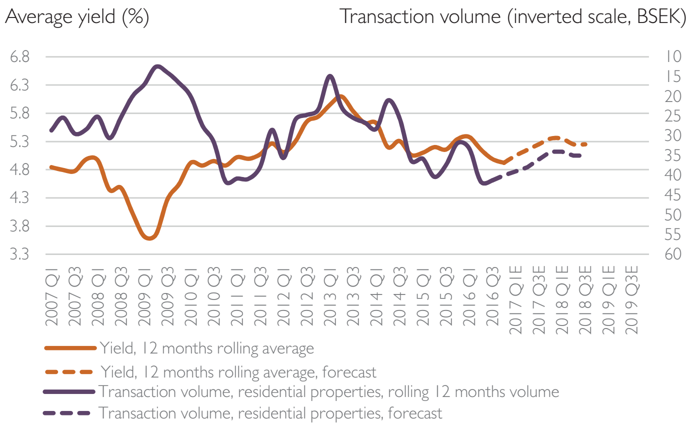
If GDP growth shrinks to approximately 1.5 per cent in 2017 and the latest trend of slightly increasing long-term interest rates continues, average property yields for rental housing properties are expected to increase by around 20–40 basis points in 2017 (up from the current level of 4.9 per cent). As with commercial property, this will mainly materialize through an increased yield gap between A, B and C locations. However, this market adjustment is expected to be brief. Because of stable rents and low vacancies across the entire country, Swedish residential property remains highly attractive.

Comment: Residential transactions in Stockholm and Gothenburg are excluded from these calculations, since the potential to convert the rental flats into tenant-owned flats in attractive locations pushes property yields down to exceptionally low levels in these cities.

Residential transaction volume and GDP growth

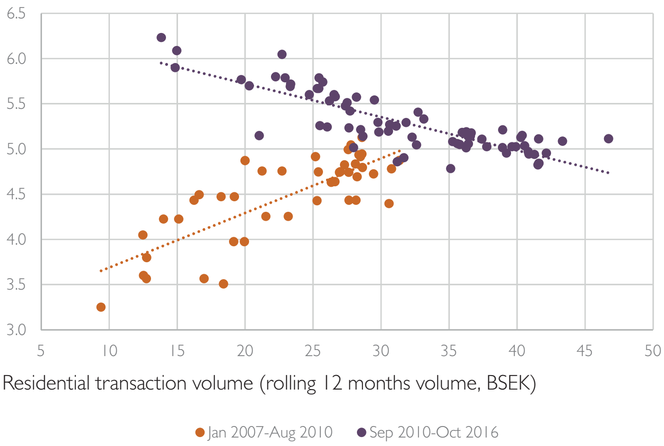


Transaction volume and average yields for residential properties



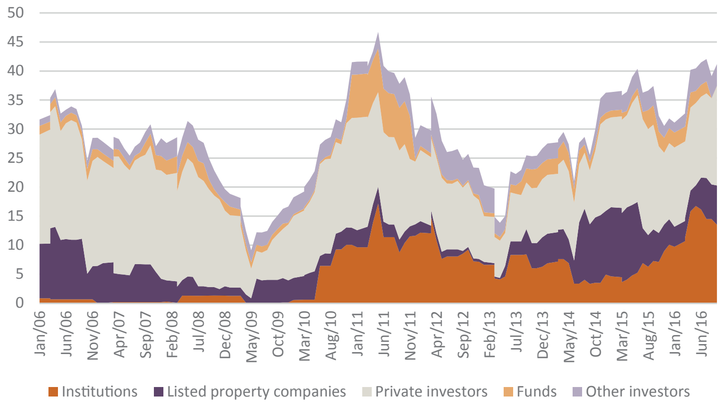
Average yields and transaction volume, residential properties, monthly data

Residential property yield (rolling 12 month average, %)*



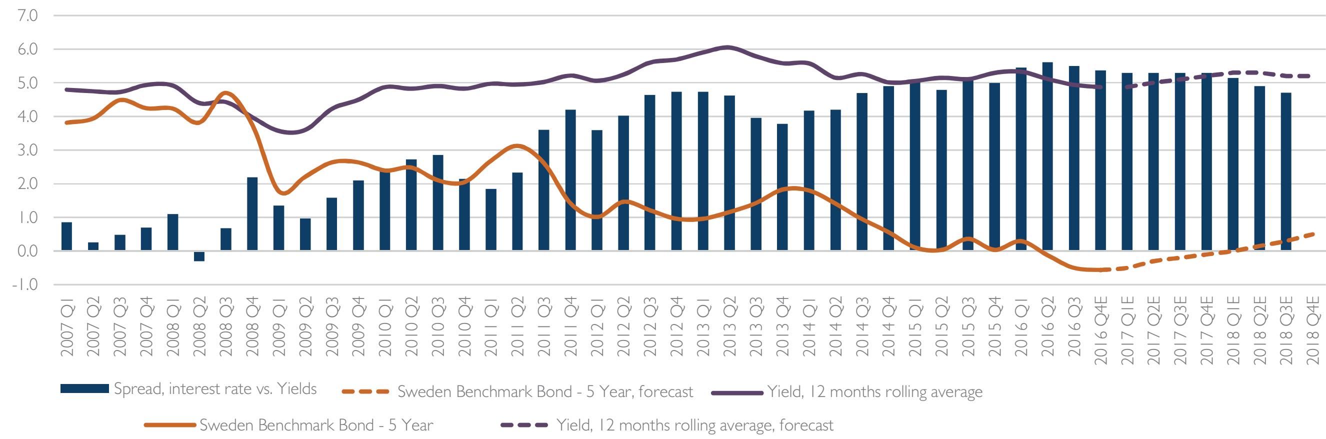
Residential investments per investor type

Residential transaction volume (rolling 12 months, BSEK)



Swedish long term government bond yields and average yields for residential properties

Yield (%)



* Yields are based on historical residential transations. Transactions in Stockholm and Gothenburgh are excluded.

Source: Factset and Catella

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