Europe - Real Estate/Property

Key takeaways on Sweden's real estate from expert call and field trip

Industry Overview

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High inflation and rates are the new normal

We invited head of research at Newsec, Adam Tyrcha, to discuss the state of the Swedish real estate markets. On the macro economy, Newsec noted that although inflation has come down in some Nordics countries, the absolute level of inflation is still high, and further levels of high policy rates are to be expected. The October CPI figure is important, as it will be used for indexation. Newsec expects the policy interest rate at 3.75% by the end of 2023. In addition, we joined BofA Global Research's G10 FX strategy and European Banks teams on a field trip to Stockholm on 8 June 2023 to meet with the regulators, think tanks and local investors (see inside for key takeaways).

Investment volume slumped in 1H23, logistics still liquid

Unsurprisingly, real estate transactions slowed significantly in 2022 and continue to be weak in 1H23; the number of deals fell sharply from >200 deals in Q4 2021 to <50 deals as of Q2 2023 (with a big 7bn SEK deal in Q2 inflating volume). The office sector should account for the largest percentage (23%) of total deals in 2023, followed by logistics, while residence and public properties are experiencing a decrease. Light industrial, which yielded 5-6% previously, now is probably at 6-7% level. But Newsec notes that deals like this still go through, and buyers might even get refinancing. Prime logistics have seen yield shift by c.150bp in the last 12 months, from 3.5% to 5.0%, even higher as few equity investors.

A closer look at recent transactions: double-digit discount

A nursing home portfolio deal in Q2 witnessed c.50-70bp yield expansion versus the original asking price, with the actual cap rate at 4-5%. Given the long leases and social housing character, yield shift in nursing homes is not as large as in other sectors. Pension fund AP7 bought an office/retail mix in Stockholm CBD at a low 3-4%. This portfolio has IKEA as anchor tenant, while the office part is of good quality and can achieve a top rent of 10k SEK/sqm. One residential new production traded at 4%ish (not 5% yet). Swedish private residential value is down 15-20% from peak and might still go down a bit further. For rental residential, however, new supply is limited, and rent is CPI indexed. Tenants in old stocks generally will not move out given the lower-than-market rent, with virtually 0% vacancy. The discount to book value in recent Q2 deals probably averages double digit % (>10%), according to Newsec.

Office holding up, but vacancy likely to increase

In general, the office market in Stockholm is still holding up, with a higher occupancy rate (5% vacancy). There is also strong interest from equity investors – central Stockholm office stocks are controlled by a few investors with a very long-term investment mindset. That said, Newsec believes that vacancy might tick up/rents go down in the future given a higher indexation. Newsec notes that investment sentiment is not that bearish in retail either given that it is mostly grocery anchored and eCommerce has a low penetration (2%) in grocery.

c.: circa

CBD: central business district

CPI: Consumer Price Index

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Takeaways from June Stockholm field trip

We joined BofA Global Research's G10 FX strategy and European Banks teams on a field trip to Stockholm on 8 June 2023 to meet with the regulators, think tanks and local investors. For real estate, we came away with the main conclusions below:

Residential

Sweden is a "world of variable rates": Sweden is a mostly floating-rate (c. 90% are floating) and low-amortization-rate market, and borrowers have built record debt over the past decade, supported by rising house prices, low rates and favourable fiscality. The positive trend in Sweden's housing market has reversed since mid-last year, and both SBAB and Finansinspektionen (Swedish Financial Supervisory Authority) estimate that residential prices are down 13% since the peak in March 2022, with a stabilisation in recent months. With the debt-to-income ratio at 200% and c. 70% of mortgages to be repriced within a year, interest-to-income should further accelerate given Riksbank's policy rate. Therefore, households could come under increased pressure, especially if energy and overall living costs remain high. On the positive side, Swedish households have accumulated a significant savings buffer, and employment remains strong – and stronger than local economists or institutions expected. According to most institutions we met at our field trip, the savings buffer has now been used (mainly to accelerate mortgage amortization). The next buffer, according to Finansinspektionen, SBAB and the Confederation of Swedish Enterprise (Svenskt Näringsliv), is households reducing consumption to continue to service their debt. The lower consumption could impact corporates, and thus employment, and hence commercial real estate demand. As Handeslbanken's head of fixed income, Mikael Rosell, summarises: "there will be pain".

While transactions in the residential market have come back partially from their trough, the supply (available apartments for sale) is well above last years' levels, according to SBAB. And for the regulated residential stock owned by institutional landlords and listed companies, there have been virtually no transactions recently due to very low rental yields (below 1%) and no privatisations, as apartments usually cannot be sold individually.

Roughly one-third of residential in Sweden is rental housing, which is slightly more than the average European country (the highest being Germany and Switzerland at > 50%). The residential rental market is strongly regulated, with rents determined annually by a negotiation between the landlord and tenants' association/unions. For 2023, for example, unions and landlords have agreed to a c. 5% rent increase. Anyone in Sweden is entitled to permanent tenancy of a rent-controlled apartment. Consequently, affordability is high: only around 8% of Swedes live in households spending more than 40% of disposable income on housing, compared to 15% in the UK. This system, aimed at guaranteeing that those who do not own property have access to quality affordable housing, has, however, created a housing "shortage"/queue and a large grey 'secondary' market (authorised subletting) and a black market (illegal subletting), where tenants pay 20% to twice as much more rent than the regulated market rent. In 2017, the Swedish government released a report according to which 25% of all leases were signed on unlawful terms, with the number probably even higher today. Rooms in flat shares are also scarce, as Sweden has a higher proportion of single-person households than the EU.

Commercial real estate (CRE)

Similar to the rest of Europe, Swedish CRE firms have increased their debt volume over the past ten years, pushed by low rates, especially through market financings (bonds). The refinancing of these bond maturities could become a topic given current cost of funding for bonds and the liquidity. At the same time, Swedish banks already have large exposure to CRE. According to Finansinspektionen, the LTV (loan-to-value) of listed and larger private CRE firms has risen from 52% last March to c. 53% in March 2023, below the almost 60% levels seen in 2014-15 but only thanks to rising asset values, as the total stock of debt has increased. Regarding debt to net operating income, today's 16x is way above the historical average of 12x. And especially interest cover (ICR), where the BofA Global Research real estate team sees the highest pressure, could quickly go to 2.0x, according to Finansinspektionen if rates stay at today's level, as Swedish CRE firms have lower debt durations than European peers. Contrary to Swedish institutions, we do not see 2.0x ICR as a comfortable level for property companies.

Finansinspektionen agrees with the BofA Global Research real estate team's view that cap rates (property net rental yields/net operating income yields) have not yet priced the current level of interest rates and should be higher given where Riskbanks rates are. Prime office cap rates are 3.7% in Stockholm, according to CBRE, which is below funding costs (Riskbank rate + credit spread). And rent growth to support cap rate expansion is likely to be limited as rents, after passing through recent CPI indexation, are increasingly slightly above market rents. The key focus for landlords is balance sheet/Investment grade rating and sale of assets. The financial regulator seems to agree that CRE firms need to deleverage, and it believes that banks need to be part of the process, by helping in the upcoming refinancings under condition of deleveraging measures.

In general, what we have observed in June is still largely consistent with our March field trip: yields are expected to rise further as investors / landlords pay more for their financing. Current buyers are equity buyers (not debt-reliant "pension capital"), and there are virtually no transactions for low-yielding assets. Overall, the market is still in price discovery mode. Past years' largest buyers (listed and private property companies) are now sellers. The most liquid market is logistics, because of higher yields (c.5% prime yield) but also because owners are willing to sell. Large transactions have not been seen so far, and contrary to past years, there is no 'portfolio premium' anymore, and portfolios now need to be split and sold on a single-asset basis. On the positive side, indexation helps rental growth. For more on other Swedish sub-sectors (self-storage, healthcare, etc.), see our 4 April 2023 report: Europe - Real Estate/Property: Key takeaways from BofA 2023 EMEA Real Estate CEO Conference.

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