Handelsbanken Research

The Ins and Outs of Swedish Real Estate

March 12, 2024

The real estate sector breathes a sigh of relief

- Interest rate cuts are approaching, but real estate stocks remain volatile
- Housing prices are rebounding, while property values continue to decline slightly
- Gloomy construction prospects, but a wave of renovations is anticipated

Foreword

In our last report in November, we noted that the property market was at a standstill. Just as the sun begins to thaw the ground, the property market is also thawing in the hope that the economy will see a soft landing, inflation will come down and the Riksbank will begin to cut interest rates. But it is still a matter of households and companies adapting to higher costs and higher interest rates than we have been used to historically. At the same time as interest rate cuts draw closer and the financing situation for many companies is easing, the economy is becoming more important for real estate companies and equity investors.

For housing construction, it is tougher. With higher construction costs continuing to rise and lower population growth, we discuss in this report whether the new normal is not clearly lower than the rate of construction we have seen in recent years. Lower housing construction can open the door to more property renovations to improve energy performance. There are new EU directives on this subject, which we believe will be important for property values in the future, not least as the requirements are likely to increase further.

We also analyse the thresholds for young people, now in the light of the government's proposals for a higher mortgage cap. High housing prices constitute the highest threshold for young people but prices differ significantly around the country, thus the effect of raising the mortgage cap varies greatly. This is something we take a closer look at.

These are some of the areas we delve into this time around and those of us who worked on the report are macroeconomists, credit, equity and sustainability analysts at Handelsbanken Capital Markets.

Christina Nyman
Chief Economist

This is an overview of the Swedish real estate market. We have also prepared a complementary slide deck as the real estate report in its entirety has not translated. You can find the slide deck on researchonline.se/macro/library. Publication date: March 12, 2024.

OUR FORECAST THE COMING YEAR	NEW	PREVIOUS
HOUSING PRICES	↗	(→)
HOUSING CONSTRUCTION	→	(→)
COMMERCIAL REAL ESTATE VALUES	↘	(↓)
REAL ESTATE SHARES	↗	(→)
YIELD REQUIREMENTS	↗	(↑)
VACANCY RATE	↗	(↑)
MARKET FUNDING	↘	(↓)
SUSTAINABLE/GREEN FUNDING	↗	(→)

Note: The forecasts on the right in brackets are from our previous report from November 2023. The arrows denote our general view for the outlook one year ahead and should not be interpreted as an assessment of the local markets.

Overview

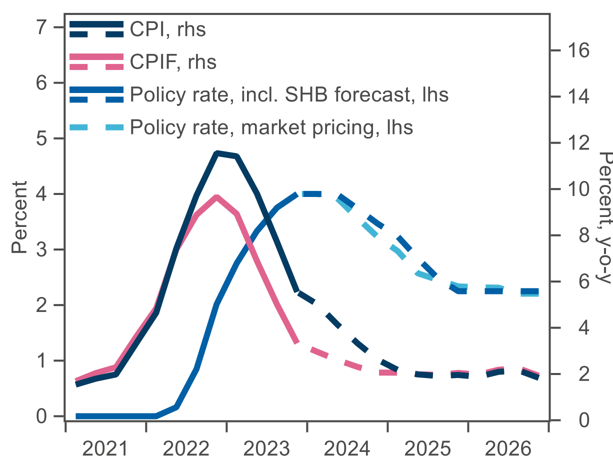
The real estate sector breathes a sigh of relief

Central banks have a soft landing in their sights and will soon begin to apply the brakes, which should ease concerns about the debt-ridden real estate sector and lend support to a credit market that is slowly thawing. Nonetheless, financing costs remain significantly higher than before, both for households and real estate companies, while housing construction appears to be stabilising at a significantly lower level. We see tough prospects for new housing production, but fresh EU directives concerning the energy performance of properties may boost renovation activity for both premises and housing. We forecast that housing prices will begin to rise this year but will increase more slowly than incomes in the coming years, while commercial property values have a little way to go before reaching the bottom.

Glimmers of hope for a soft landing...
Inflation is falling and the conditions for a soft landing in the economy have improved over the past six months. The huge imbalances created by the crises of recent years are normalising, although geopolitical instability such as the attacks on freight shipping in the Red Sea continue to pose a risk of renewed supply disruptions and higher input costs. While there is still some way to go to reach the inflation target, the downward trend is clear and central banks have shifted their communication and are increasingly focusing on future prospects and not risking exacerbating the labour market's current weakness.

Our forecast is that inflation will decline gradually and reach the target by the end of the year. As for the October CPI figure, which is key for the rental market, we estimate that it will be around 3 percent in 2024. This suggests that rent increases in 2025 will also be somewhat higher than normal.

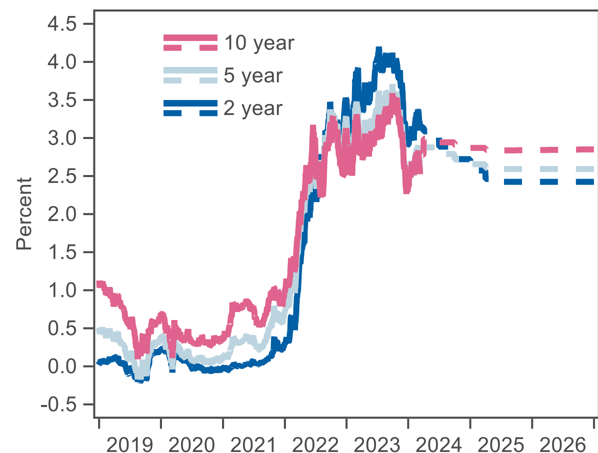
Focus shifted towards interest rate reduction



Sources: Macrobond, Statistics Sweden and Handelsbanken

...but fixed income markets reflect uncertainty
Based on our assessment, the fixed income market will remain sensitive to incoming data linked to the inflation outlook. At present, although the direction is clear, uncertainty revolves around the timing and speed of the rate cuts. Nonetheless, a soft landing is fraught with risks – setbacks in the fall in inflation could postpone interest rate cuts and prolong the economic downturn while a clear deterioration in the economy could trigger more aggressive rate cuts.

Market rates (swaps) have reached their peak

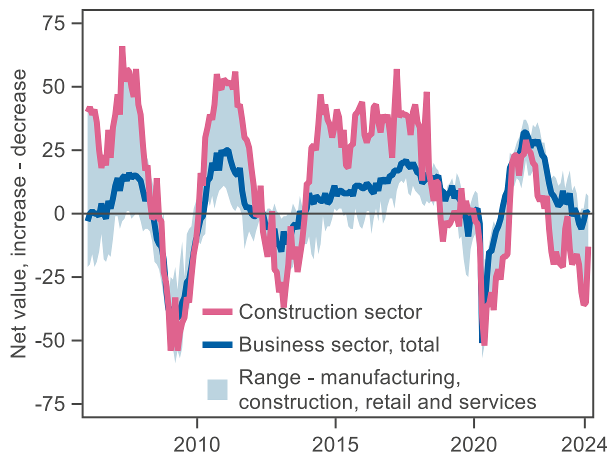


Sources: Macrobond, Riksbanken and Handelsbanken

Currently, the 2-year market rate is just above 3 percent, while the 5- and 10-year yields are about 0.5 percentage points lower. This can be interpreted as the market (like us) expecting current short-term interest rates to be higher than normal. We expect the Riksbank to begin cutting its key interest rate in June of this year, followed by two further cuts later in the year. The prerequisite for interest rate cuts is that the inflation rate continues to fall. In 2025, we believe that the Riksbank will cut its key interest rate at a slightly faster pace, and that by the end of the year it will stand at 2.25 percent; a level that, in our opinion, neither tightens nor stimulates the economy. For households, our forecast suggests mortgage rates converging towards 3.5 percent, on both variable and fixed contracts. Ahead of us is thus a period of declining interest costs for households, although in 2026, they will still be roughly twice as high as they were in 2022. Housing costs will therefore remain

significantly higher than before, which will dampen the recovery of both household consumption and the housing market.

Recruitment plans send mixed signals



Sources: Macrobond, NIER and Handelsbanken

Employment is falling, mainly in construction

The previously record-strong labour market has begun to cool and unemployment has rebounded. Forward-looking indicators, such as hiring plans, suggest that demand for labour will remain weak in the coming months. We expect employment to decline slightly in the first half of 2024 and for unemployment to peak at 8.3 percent at the end of the year.

Last year, production and employment in the construction sector were sustained by continued high levels of commercial construction and the completion of thousands of homes. However, employment in the construction sector is difficult to assess, as the official labour market statistics LFS show on the one hand that employment in the sector clearly decreased in 2022, while register data from Statistics Sweden (BAS and NR respectively) shows a more stable development. According to Statistics Sweden, the decline in the LFS was largely driven by the self-employed category. Bankruptcy statistics also show that the increase in bankruptcies in the construction sector has mainly been driven by companies with fewer than ten employees.

During the autumn, the number of redundancies in the construction sector increased sharply and, according to the National Institute of Economic Research (NIER), companies in the construction sector are planning to reduce their workforces further. Our assessment is that we will not see a collapse but rather declining employment in the construction sector during the year as ongoing construction projects are completed without being replaced with new projects. Our forecast for construction investments points to the number of people employed in the construction sector falling by around 10,000 in 2024.

Housing construction is moving towards a new normal

The growth outlook one year ahead seems to be heading towards a period of normalisation, and we expect the number of construction starts to stop falling. Our assessment, however, is that there will only be a small increase in housing construction in the coming years and that housing construction is heading towards a new lower normal of around 35,000 thousand housing starts per year, rather than returning to previous record-high levels. One reason for our more negative view is that population growth has slowed sharply, another is that construction costs are expected to remain high. This suggests that there will be tougher competition for jobs in the construction sector and that the number of people employed in the construction industry will also stabilise at a new lower normal level.

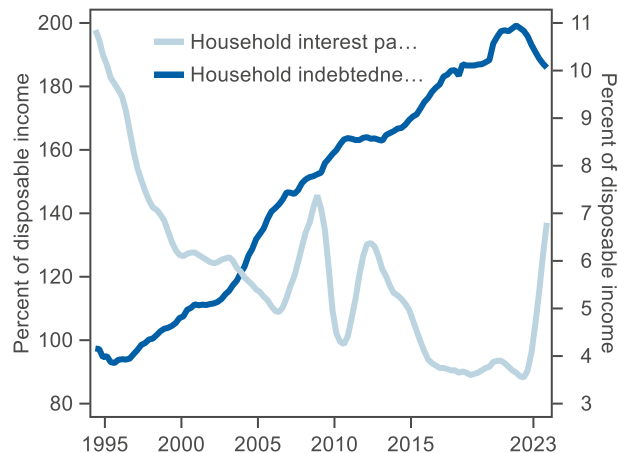
Home prices starting to rise, but without recoil

Housing prices have remained virtually unchanged over the past year and we now expect to witness a gently rising trend that will begin towards the summer. The supply of housing objects for sale is certainly very high, but we do not see much evidence to support the view that sellers will lower their price expectations drastically. Rather, improved prospects and lower interest rate expectations among households tend to be accompanied by stronger purchasing power and increased turnover. Our forecast is that home prices will rise by an average of 0.5 percent this year and will increase in line with households' disposable income in 2026. This is weak from a historical perspective and is largely explained by higher interest costs and limited opportunities for households to take on more debt.

In recent years, Housing costs have primarily increased for tenant owners and single-family homeowners. However, on average, rental apartment owners still spend a slightly larger share of their income on housing. Going forward, we expect housing costs to fall for those with owner-occupied homes and the debt-to-GDP ratio to level off. The government's proposed increase in the mortgage cap and governmental investigation of the macro-supervisory measures such as mortgage ceilings and amortisation requirements suggest that there will be relief in this area, but probably only

provided that indebtedness is not assumed to pick up again.

High debt, but interest costs remain low

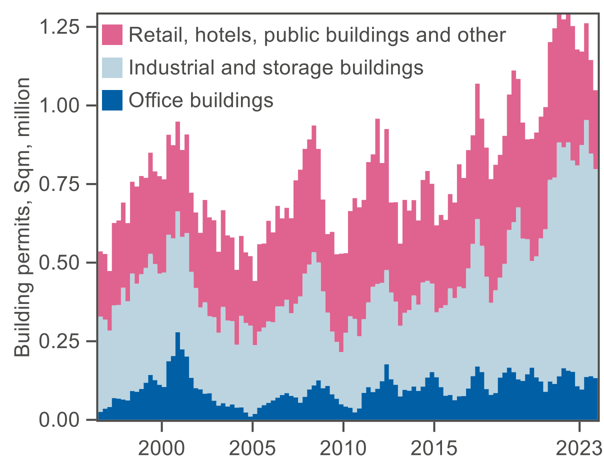


Sources: Macrobond, Statistics Sweden and Handelsbanken

Increased focus on energy performance

In contrast to the decline in the number of housing starts and renovations, other investments are doing relatively better. Major investments are linked to Norrland and the green transition, which has given a boost to the construction of new industrial and warehouse premises in recent years and lifted the investment outlook for the next decade. In addition, many premises, not least offices, require renovation in order to become fit for purpose and in demand. In this report, we highlight a continued strong focus on the energy performance standards for buildings, which should further boost the rate of renovation.

Commercial real estate construction



Sources: Macrobond, Statistics Sweden and Handelsbanken

In December, the EU reached a preliminary agreement on higher requirements for buildings' energy consumption and an associated reduction in their impact on the climate. The requirements regarding the energy performance of existing properties are generally in line with our expectations, with more stringent requirements for non-residential buildings than for residential buildings. Details of implementation in Sweden are still to be negotiated, but the requirements for housing in 2030 and 2035 do not seem to have had a dramatic effect in relation to the observed historical rate of energy efficiency in the housing stock. That said, we still forecast that energy performance will have a greater impact on a building's attractiveness and valuation than has been the case historically, both for commercial buildings and housing, as we expect energy performance requirements to continue to be tightened. A greater focus on energy security and increased need for electricity linked to the electrification of many sectors are two additional drivers for this, in addition to new requirements for sustainability reporting that will increase tenants' interest in the climate impact of buildings.

This creates risks to the downside for players who do not live up to the requirements, but also to the upside for those who have the capacity to invest in renovations related to improved energy efficiency.

The credit market is slowly thawing

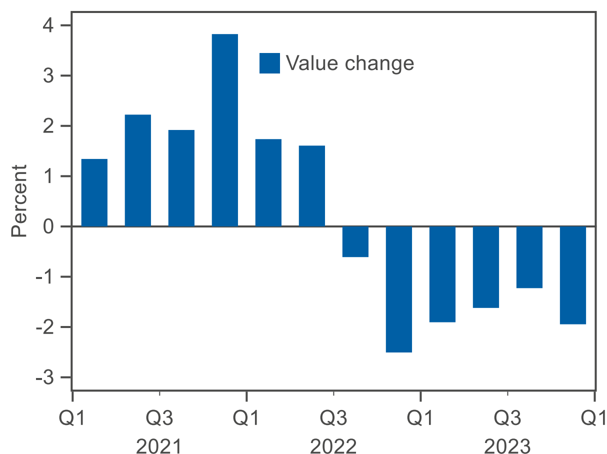
The big decline in long-term interest rates and real estate sectors' credit spreads towards the end of 2023, combined with the fact that credit rating agencies proved to be more flexible than we had previously thought, meant that real estate companies went from ice-cold in the bond market to being sought after by investors at least in the Swedish market. We note that the pressure on credit ratings has eased for a large group of companies that have their balance sheets under control. So far, it is primarily the Swedish market that has shown itself to be willing to finance real estate companies, and we believe that the sector will be able to refinance a large part of its maturities in 2024. Investors continue to see value in credit spreads, at least when they have confidence in the credit ratings. Our assessment is that credit spreads for real estate companies will continue to move closer to the spreads of companies in other sectors. We are generally positive about the credit market and expect credit spreads to narrow in 2024.

Property values are falling, but not for long

Since mid-2022, commercial property values have fallen by an average of about 10 percent. According to MSCI, property values declined in all segments, although offices fared slightly better than industrial and residential properties in 2023. The pressure on companies' interest coverage will continue in 2024, but will not have as great an impact as we had previously thought, partly because credit rating agencies have shown themselves to be

unexpectedly flexible in their requirements. The decline in long-term interest rates has also eased financial pressure on the real estate sector.

Changes in value compared to opening value



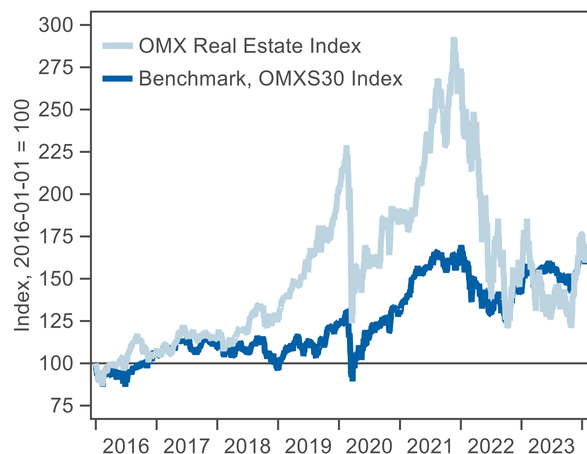
Sources: Sedis and Handelsbanken

So far, the low number of vacancies and higher rents have meant that it has looked quite stable. However, looking ahead, we expect vacancies to rise slightly and rents to fall. We expect to see further property value writedowns and the transaction market, in general, to become more active in 2024 as conditions improve. Further writedowns increase price transparency, i.e. it becomes easier for buyers and sellers to agree on price. In addition, continued rising dividend yields, not least relative to financing costs when variable interest rates turn downwards, make the calculations look more attractive to potential buyers. We stand by our view of an average decrease in value from the peak in 2022 of about 15 percent.

The stock market is tossed back and forth

2023 saw rapid and numerous fluctuations in sentiment, stock prices and stock valuations, with interest rate volatility and central bank communications having a major impact on the stock market. Perhaps the most remarkable price movement was during the final months of 2023, when the property index soared by more than 40 percent from the end of October until year-end, with a slight decline in early 2024. It is evident that investors took note of upcoming interest rate cuts and dismissed the danger for the heavily interest-burdened sector. However, the direction now, at a higher valuation level, is hard to assess. However, current sentiment, at higher valuation levels, is difficult to assess and the euphoria caused by falling interest rates has dampened as interest rates have rebounded. The focus is now shifting to the course of the economy and the effects that it will have on real estate companies.

Quick moves in real estate stocks



Sources: Macrobond, Nasdaq OMX Nordic and Handelsbanken

We note that real estate shares are generally still valued at a discount to net asset values, which in our view is reasonable given the outlook for earnings growth, which looks set to stagnate or even be negative in 2024. On average, shares in the sector are valued at a net discount of 10 percent based on reported values in the fourth quarter with a median of 18 percent, which adjusts for a couple of stocks with very high valuations.

The housing and office segments trade at discounts as investors partly worry about loan-to-value ratios (housing) and partly demand (offices). The heavy-weight **office segment** is valued at an average discount of 23 percent, implying a theoretical discount to reported values of around 13 percent. This is not a crisis valuation, in our view, as we expect further value adjustments during the year owing to a delayed effect of the higher financing costs. **Residential** real estate companies are still suffering from the sector's largest valuation discounts despite the fact that the low-yielding assets have seen fairly large declines in value during 2023, partly due to lower rent adjustments than for the commercial portfolio.

We believe international investors' view of the sector is overly negative in terms of pricing and valuations. A more nuanced picture over time suggests a less negative impact on stock prices based on sceptical foreign investors. After this year's fall in share prices, we are significantly more positive about real estate shares than a few months ago. The combination of some profit growth as early as 2024, low valuations and low operational risk means that we are now slightly overweight towards Buy/Outperform recommendations.

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