Real Estate Research

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DWS

Nordic Real Estate Strategic Outlook

Third Quarter 2022

IN A NUTSHELL

- Economic growth across the region will likely be weaker in the short term, as high inflation weighs on consumer spending. However, the Nordic economies look well placed for long-term growth.
- The residential sector should prove resilient to economic disruption, supported by positive demand and supply fundamentals. We favour affordable residential schemes, particularly in well-connected commuter locations.
- We anticipate that the logistics sector will continue to perform well, particularly in supply-constrained, urban locations. Stockholm's office market is expected to prove successful over the longer term as high-productivity sectors encourage further growth.

Across Europe, the first half of 2022 has been defined by rapidly rising inflation and weakening economic growth. Despite proving more resilient during the Covid-19 pandemic, the Nordic economies are also now experiencing an economic slowdown, as persistent inflation starts to squeeze household incomes. Borrowing costs have increased sharply in a volatile fixed income market and as a result, like elsewhere in Europe, a price correction in the Nordic real estate market is now underway. Over the next 18 months we anticipate an outward yield shift across almost all sectors. Yields are now expected to peak much earlier in the cycle than we had previously forecast, before recovering slightly over the longer term as the economy picks up pace again and investment activity returns. However, towards the back end of the ten-year forecast period, our outlook for property yields remains largely unchanged.

Economic outlook downgraded

Like elsewhere in Europe, the Russian invasion of Ukraine has had a severe impact on the Nordic economic landscape, and we have downgraded our outlook for growth, particularly in the short term. Dependence on Russian fossil fuels is minimal in the Nordics, where the use of renewable energy sources is far more advanced.[1] Nevertheless, the region is not immune to global supply chain issues and rapidly rising inflation. Consumer sentiment has plummeted to levels well below the worst of the coronavirus pandemic[2] while increasingly squeezed household incomes will likely put pressure on economic growth going forward.

In response to risks around heightened inflation, the Nordic central banks, alongside the ECB, have all increased interest rates. Further monetary tightening is also expected over the remainder of the year. An economic downturn over the next year is

[1] Oxford Economics, July 2022
[2] European Commission, July 2022

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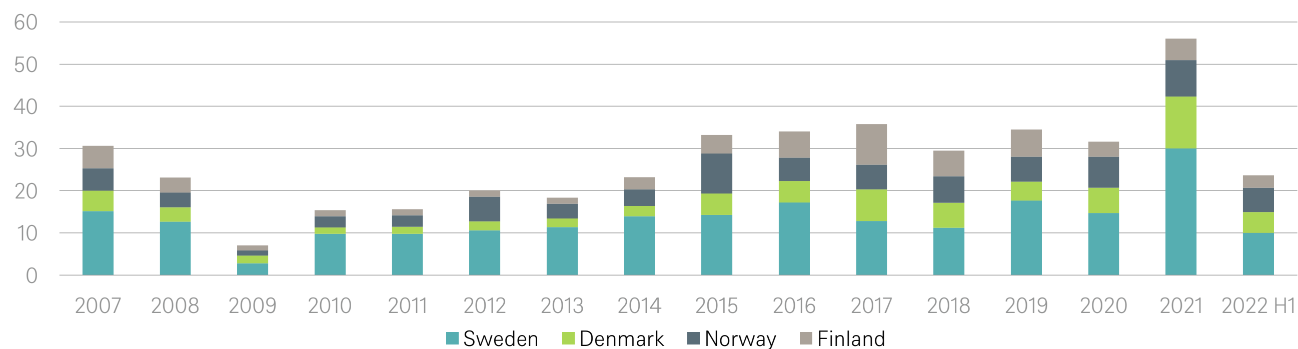
becoming an increasingly likely prospect, yet the longer-term outlook for growth remains positive. At the national level, Denmark and Sweden in particular are anticipated to outperform within the European Union, while the major Nordic cities are supported by strong urbanisation trends, which should drive stronger-than-average GDP, employment and population growth.[3]

Challenges for the real estate market

Over recent years, real estate investors have increasingly targeted the Nordic countries, attracted by solid growth fundamentals, alongside slightly higher entry yields than other Core European markets. However, the Nordic real estate market is now faced with a number of immediate challenges, particularly with regard to higher financing costs and slowing economic growth. As such, like in the rest of Europe, we anticipate a slowdown in real estate investment over the coming year.

To date, evidence of a slowing market has not yet been seen in the data. Provisional figures suggest all property quarterly investment volumes across the region totalled €11.4 billion in the second quarter of 2022, representing only a slight decline on the previous quarter and still well above the long-run average. Denmark in particular continued to see strong levels of investment compared to its historical trend, although Sweden remains comfortably the largest market by volume.[4] The Nordic residential sector continues to drive the bulk of demand, accounting for 38% of total investment volumes over the first half of the year.

Transaction Volumes by Market (€ billion)



Source: RCA, July 2022.

At present, evidence of a price correction is largely anecdotal. While any movement in yields remains minimal or non-existent according to the data currently available, we are aware of several large real estate transactions in recent months where the price has been renegotiated or the deal put on hold. Over the next 18 months, we expect yields to move out across most sectors, with prime values anticipated to decline by up to 15%. The office sector is expected to see the largest correction given its exposure to wider structural trends such as remote working.Supported by stronger rent growth, logistics and residential should see a more modest decline in prime values. Secondary, low energy-rated properties could well see even greater value declines.[5]

Nordic residential should prove resilient

Despite economic headwinds, residential markets in the Nordic capital cities are still supported by solid fundamentals. A strong urbanisation trend across the region will continue to bolster demand for mass-market private rental schemes, both within city centres and in suburban commuter locations.

[3] DWS, July 2022
[4] RCA, July 2022
[5] DWS, July 2022

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Copenhagen stands out as the top-performing residential market in Europe over both the five and ten-year forecast period.[5] We continue to favour more affordable accommodation on the outskirts of the city centre, in well-connected commuter locations such as Herlev and Rødovre. However, we also see opportunities in Denmark's largest regional cities, such as Aarhus, supported by a large university presence and solid employment prospects.

Stockholm's residential market is also supported by strong fundamentals, with supply being particularly tight. The highly regulated nature of the Swedish residential market has ensured that new supply has not kept pace with household formation for many years, resulting in a significant shortage of rental housing. Until now, strict regulation has prevented realising strong rental growth on existing standing assets, and with prime residential yields in Stockholm falling well below 3.0%, investment opportunities were often unviable. However, it has recently been announced that rent regulation on new residential development will be eased significantly.[6] While the true impact of this remains to be seen, it could drive healthier returns for investors.

Helsinki remains the underperformer of the Nordic residential markets, although we have upgraded our outlook for rental growth slightly. Having had concerns over the city's supply pipeline, which at the end of last year looked likely to exceed demand in the short-term, there has been a significant increase in construction costs over recent months, as well as increasing concerns over economic uncertainty. This appears to have tempered developer activity, and future supply indicators would now suggest a slowing in development over the coming years.[7] Given future demand indicators in Helsinki remain strong, a fall in residential construction activity should erode elevated vacancy rates and support more positive rental growth over the longer term.

Logistics well placed to withstand economic disruption

The fundamentals behind logistics remain solid. Healthy demand has driven down available supply, and vacancy is tight across most markets. However, while market fundamentals should support further strong rental growth in the short term, the logistics sector is not immune to wider economic disruption. Lower consumer spending and slowing e-commerce growth will likely impact demand, with net absorption expected to fall back from exceptional heights to levels more in line with the pre-pandemic average. Substantial cost increases, particularly fuel and energy, could further squeeze already thin tenant operating margins. With that in mind, we see less impetus behind logistics rents over the longer term and expect rental growth to be more in line with long-term inflation.

The exception here is urban logistics, where extremely tight supply and competition from other land uses is expected to continue driving strong rental growth over the forecast period. In particular, we see the best opportunities to achieve higher returns through the redevelopment of ageing logistics assets in urban locations around Stockholm and Copenhagen.

[6] Green Street, August 2022
[7] Statistics Finland, July 2022

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Prime Total Return Forecast (2022-2031f, % p.a.)

Source: DWS, July 2022. Note: F= forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

The office sector remains an underperformer overall. We expect a further weakening in the occupier market as both output and employment growth slow over the short term and businesses continue to re-assess their requirements for office space. As such, the office sector could well see a slightly larger price correction than the other sectors, especially at the lower end of the quality spectrum.

That said, we anticipate that Stockholm will prove to be one of the better performing office markets, especially as the economy enters a period of recovery. Stockholm is supported by fast-growing, high-productivity industries that typically favour best-in-class office space with the highest ESG credentials. With that in mind, as price corrections are realised across grade B stock, we see an opportunity in the refurbishment of older, but well-located office stock into 'Next Generation' office buildings, with a focus on environmental sustainability and employee wellbeing. In our view, this value-add approach could lead to greater risk-adjusted returns, and a more positive carbon impact, than lower-yielding, new-build stock.

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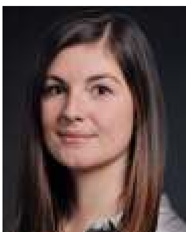

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