For professional investors only, in Switzerland for Qualified investors only – not for use by retail investors or advisers.

Nordic Real Estate Market Outlook

Q2 2020

"Monetary, fiscal and regulatory responses have already followed economic lockdowns and social distancing measures across Europe, as a result of the rapid spread of Covid-19. We don't, however, expect these measures to offset a European recession."

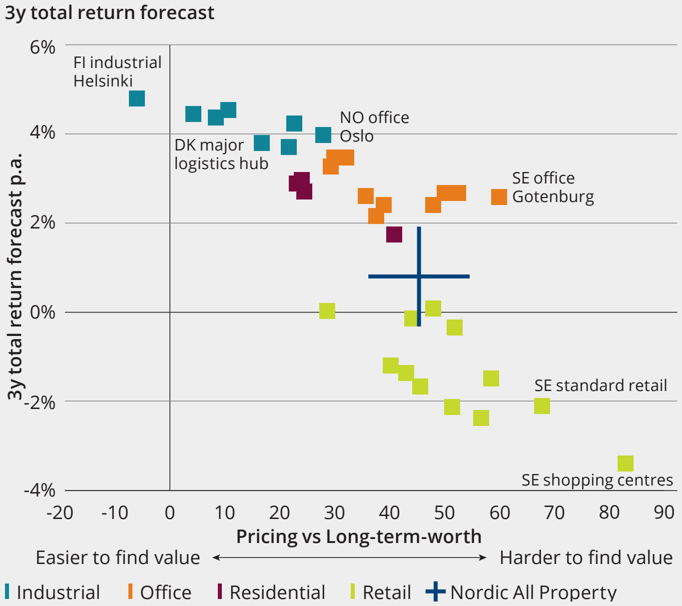
Executive summary

- Monetary, fiscal and regulatory responses have already followed economic lockdowns and social distancing measures across Europe, as a result of the rapid spread of Covid-19. We don't, however, expect these measures to offset a European recession.
- Our baseline forecast is for Eurozone gross domestic product (GDP) growth to contract by circa16% in the first half of 2020, with a slower recovery over the second half of the year and beyond relative to the size of the initial shock.
- The Nordic region is likely to experience a major downturn in economic activity as well, being particularly exposed to global trade and integration with European supply chains. We have observed governments introduce several responses across the region in an attempt to help all layers of the economy, lowering interest rates as well as supporting businesses and private individuals.
- Investment activity was surprisingly strong in the first quarter of 2020 but, considering the elevated uncertainty, we expect activity to drop across the region over the short term. Although interest rates are historically low and likely to support real estate yields over the medium term, financing has become increasingly difficult to obtain.

Economic outlook

- Monetary, fiscal and regulatory responses have already followed economic lockdowns and social distancing measures across Europe, as a result of the rapid spread of Covid-19. We don't, however, expect these measures to offset a European recession. Although the depth and magnitude of the downturn is difficult to quantify, our latest baseline forecast is for Eurozone GDP growth to contract by circa16% over the first half of 2020. The recovery over the second half of the year and beyond is likely to be slower, relative to the size of the initial shock. Member states that have been able to control the virus more rapidly, such as Germany, should experience shallower recessions.
- The Nordic region is likely to experience a major slowdown in economic activity as well, culminating in what will be a very sharp and deep contraction. Small and open economies, like the Nordics, are exposed to global trade, and their integration with European supply chains will only amplify the impact of the outbreak.
- Although official business surveys are not concluded as of yet, it is likely that business confidence across the region will plunge to levels similar to those seen in the Eurozone. This is consistent with a rapid deterioration in industrial production. Consequently, investments are likely to be pushed back to the second half of the year and beyond.
- In terms of monetary and fiscal responses for the Nordic region, we have observed governments introduce several responses in an attempt to help all layers of the economy. These include lowering interest rates, as well as supporting businesses and private individuals directly and/or indirectly. On average, these responses amount to 2.5-7.5% of GDP across the region.

Chart 1: Market pricing versus long-term worth and three-year forecast returns[1]



Source: Aberdeen Standard Investments, April 2020.

[1]Forecasts are not a reliable indicator of future performance and there can be no guarantee that these will be achieved

"All sectors are likely to be impacted one way or another, although we find the retail and hotel sectors in particular to be adversely affected. The exception is supermarkets and other forms of food-retail, which have shown strong operational resilience. The damage to the retail sector, however, might prove more permanent than for hotels, where demand is likely to improve once travel restrictions are lifted."

Property and the capital markets

- Nordic property funds delivered an average total return of 7.7% (in EUR) during 2019, of which distribution accounts for 4.0% according to MSCI/IPD. Property performance was generally strong across the region. Sweden outperformed the other Nordic countries with an average return of 10.3%, while Finland and Norway were at the lower end, averaging 8.8% and 7.7% respectively. Although these numbers are strong on a relative basis, performance is expected to fall in the short term, following our baseline assumptions of economic contraction.
- This view includes an expected fall in capital values in the short term, which we believe stems mainly from yield levels moving out. However, temporary and permanent loss of income from a combination of lower rental levels, lower inflation indexation and higher void contribution is a factor likely to drag on capital values as well.
- All sectors are likely to be impacted one way or another, although we find the retail and hotel sectors in particular to be adversely affected. The exception is supermarkets and other forms of food-retail, which have shown strong operational resilience. The damage to the retail sector, however, might prove more permanent than for hotels, where demand is likely to improve once travel restrictions are lifted.
- In terms of the listed equity market, share prices fell sharply as the threat of Covid-19 became apparent. While markets collectively are down year-to-date, we have observed some positive recovery for the aggregate equity markets. The listed real estate market has not experienced a rally to the same extent as of yet.
- While lending is available to a certain degree, indications are that the cost of debt is increasing significantly as liquidity costs are widening. In fact, the April edition of Catella's credit survey shows a sharp decline in the main index from 49.5 to 33.7, indicating the worst credit market sentiment they have observed since inception of the index. Banks have become much more selective in terms of sectors, with limited willingness to finance retail and hotels. Banks also have problems in assessing the value of properties. Many have taken security precautions by reducing value estimates for assets when considering new loans. So far, banks seem to be flexible in negotiating temporary suspensions of ICR covenants.

Property market performance

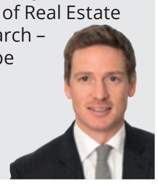
- Although March was a less active period in terms of investment volumes, the first quarter of 2020 was stronger than the first quarter of 2019, according to Pangea Property Partners. In fact, over the past twelve months including the first quarter of 2021, Nordic transaction volumes have reached EUR 46.2 billion. However, it is likely that deals started in late 2019 and closed in the beginning months of 2020 are not reflective of the Covid-19 outbreak. Therefore, they are not representative for our short-term expectiations of lower activity across the region.
- This implies that we expect both domestic and foreign investors to hold back on further investments for the time being, despite being in a low-interest-rate environment. Overseas investors have been net buyers, accounting for some 40% of the buy-side activity in the region over the last twelve months. This suggests they are a large portion of market liquidity. We expect the drop in activity to be at a level where it affects pricing of real estate properties. However, it is likely to vary depending on asset-specific characteristics.
- Following our baseline assumptions of economic contraction, we expect all sectors to be affected one way or another, although some sectors might prove more resilient than others.
  - **Office:** the office market was generally in a strong position before the crisis, with low vacancy rates and positive rental growth. Given the circumstances, we have lowered our short-term outlook. Where we previously expected positive rental growth for good and efficient office buildings, we currently expect zero (or even modestly negative) rental growth for the same properties. While development is expected to grind to a halt, our expectations follow the assumption of both higher unemployment rates and vacancy levels.
  - **Retail:** the sector faced challenges even before the Covid-19 outbreak. While stores are temporarily being closed by governments, many retailers have chosen to close their stores, as they are unprofitable. For example, H&M has closed almost 3,500 out of its 5,000 stores globally. Although we expect some of the damage to the retail sector to be permanent and capital values to plunge, supermarkets and other forms of food-retail have proven operational resilience.
  - **Industrial/logistics:** some of the potential long-term structural changes assumed to follow this crisis further support our conviction in the sector. For instance, faster adoption of e-commerce and potentially larger inventories are likely to fuel even more demand for logistics space over the medium to long term. Therefore, on a relative basis, we find this sector to be one of the most resilient.
  - **Residential:** the private residential sector should also prove more resilient, even if cash flows take a hit from rising unemployment levels and rental holidays. Furthermore, we expect tenant turnover rates to drop significantly in 2020, while re-letting or first-time letting after completion will be more challenging and time-consuming. Therefore, our projections are for rental growth to be below trend but picking up after the crisis.
- We expect capital values to fall as a result of both yields moving out and potential income loss. However, transacted properties do not yet suggest a shift in yield levels from those of Q4 2019. Additionally, valuation reports that have come through hold a disclaimer stating that owing to uncertainty, 'actual' valuations are unavailable and therefore valuations are based on Q4 19 levels.

"Most short-term indicators for the property markets have shifted downwards. The poor economic outlook combined with zero (or negative) rental growth expectations for the office market across the region and lower access to financing have lead us to revise our leading indicators down significantly."

Investment themes and outlook

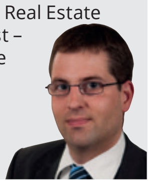
- Most short-term indicators for the property markets have shifted downwards. The poor economic outlook combined with zero (or negative) rental growth expectations for the office market across the region and lower access to financing have lead us to revise our leading indicators down significantly.
- Nordic investment activity was particularly strong in the first quarter of 2020, predominantly in the first two months of the year. However, we expect activity to drop in the short term owing to high uncertainty. That includes lower activity from both domestic and foreign investors, which is likely to affect pricing of real estate properties.
- We have yet to complete a revised fundamental value analysis but it was clear even before the crisis that that market prices, on aggregate, were well above our estimate of fundamental value. For a while, we have been advocating a lower-risk approach and believe it's even more appropriate in today's environment. This includes reducing the use of leverage, selling potentially risky assets where possible, and investing in our properties to improve quality and reduce future vacancy risk, if possible and/or necessary. Another element is maintaining sufficient liquidity buffers to offset potentially adverse effects on cash flows.
- The one risk we feel comfortable taking, assuming normal market conditions and a sound rental market, is risk related to our own asset management capabilities. Quality properties with good locations but with some vacancies or short leases can provide good value for investors with strong asset management capabilities. This is particularly true within the office sector. However, we are careful not to fully pay for the future uplift of rents in under-rented properties.
- We remain cautious regarding those retail formats most exposed to increasing competition from e-commerce, including average fashion-oriented shopping centres and quality high-street shops. The retail industry has historically been dependent for growth on opening new shops. Structural changes are now leading to a net reduction in shops rather than an increase. Margins for many major retailers are under pressure and we believe this will influence rent affordability for their shops.
- Groceries, services and experiences are more difficult to sell online, and we believe retail formats focusing on these segments will be much more resilient. In particular, we like convenience retail centres linked to public transport hubs. Prime big-box retail destinations may also do well, owing to much lower rental levels than in general shopping centres and city centres, allowing cost efficiency.
- From a top-down perspective, industrials/logistics is the most attractively priced sector. The logistics sector is benefiting from the growth of online retail, which is driving some strong take-up volumes. There is also strong demand for 'last mile' delivery hubs for retail goods bought online. However, the lack of industrial/logistics land experienced in the larger European cities is less severe in the Nordic cities.
- The residential sector can offer core investments with low risks and more value-add opportunities. Identifying good opportunities can be difficult, though, as there is fierce competition among investors for residential stock. The decline in house prices may lead to more projects initially intended for the owner-occupier market being sold as rental properties. It's likely many developers will need to offload projects from their balance sheets, which may provide interesting opportunities.

Lars Flaoyen
Head of Real Estate Research – Europe



Craig Wright
Senior Real Estate Analyst – Europe

Stephan Schanz
Senior Real Estate Analyst – Europe



Jon Vetrhus
Real Estate Analyst – Europe

The value of investments and the income from them can go down as well as up and your investor may get back less than the amount invested. Real estate is a relatively illiquid asset class, the valuation of which is a matter of opinion. There is no recognised market for real estate and there can be delays in realising the value of real estate assets.

Important information

For professional investors only, in Switzerland for Qualified investors only – not for use by retail investors or advisers.

Contact Us

To find out more, please speak to your usual contact or visit our website **aberdeenstandard.com.**

Other important information

Visit us online

aberdeenstandard.com

AberdeenStandard Investments

121041555 04/20 | DH: NO-040220-109155-3