Analysis

Finnish commercial property market increasingly intertwined with foreign markets

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The property market in both Finland and in the other Nordics has attracted increasing interest from foreign investors. Global risks may carry over onto the Finnish property market through foreign investors. An adverse economic shock may cause property values to fall and prompt a share of foreign investors to withdraw from the Finnish market. Consumer behaviour is being reshaped by urbanisation and digitalisation, with important ramifications for office and retail property investments.



Brisk trading on Finnish property market continues

When interest rates are low, investors seek returns from markets that are less liquid than those for equities and bonds. Property investments have offered steadier and higher returns than many other asset classes in recent years. However, with property valuations having now persisted at high levels on many important markets in both Europe and the United States, investor interest has shifted towards countries that lie on the geographical periphery of Europe, such as Finland.[1]

Investment continued to flow briskly into the Finnish property market in 2018, despite moderating slightly on 2017.[2] According to KTI[3], the volume of major real-estate transactions in Finland totalled some EUR 9.3 billion in 2018. As in 2017, this figure was bolstered by large, individual transactions carried out by foreign investors.

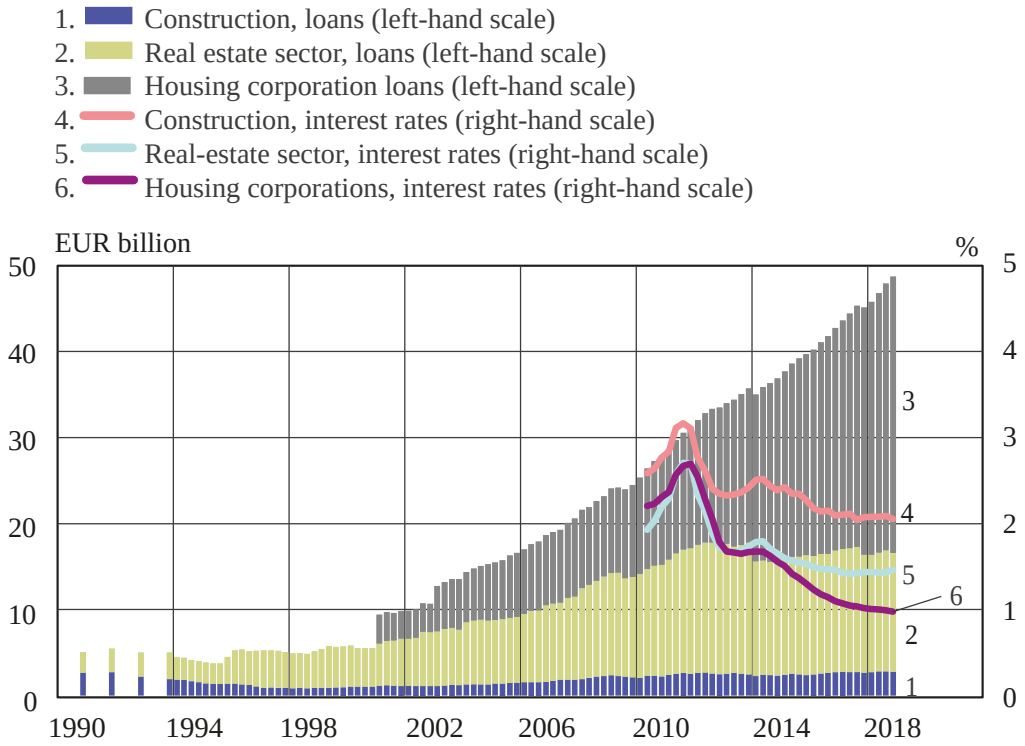
In 2018, foreign investors accounted for 66% of all new investment flows into the Finnish property market. Foreign investors also increased their share of the stock of investment properties owned by professional investors, reaching 30% at the end of 2018.[4] A significant portion of international investors who partake in the Finnish property market come from other Nordic countries, most notably from Sweden.

Institutional investors' keen interest in the Finnish investment property market, and especially in the Helsinki metropolitan area, has increased the market's size while pushing down property yields.[5] In addition, foreign investor activity has further strengthened the property market's growth, both in terms of size and in terms of valuations. In particular, the yield requirements on

prime investment properties[6] located in Helsinki's central business district have declined much more quickly than in other regions, underscoring the strong rise of property prices in Helsinki compared with the rest of Finland. Yet in spite of strong investor demand, Finland as an investment locale still remains less bid and more affordable than many other European countries.

Chart 1.

Domestic banks' real estate-related loan stock grown rapidly in past 20 years



Sources: Bank of Finland and Statistics Finland.

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The Finnish property market is strongly tied to the performance and price developments of other property markets in Europe. There is a risk that a significant deterioration of market conditions in Europe or in the Nordics could prove disruptive to the property market in Finland. Foreign investors have historically responded to changes in general market conditions more forcefully than domestic investors.[7]

A negative economic shock would lower property prices and especially influence the behaviour of

speculative and highly leveraged investors. Lacklustre market performance would make it more difficult to refinance property investments on bond markets, which have become an increasingly important source of finance for property investment companies. The retreat of a significant number of foreign investors from the Finnish property market could drive down property prices even further.

Property market split by urbanisation

Statistics Finland's regional population projection shows that the proportion of people of working age in the population is growing especially in cities with over 100,000 inhabitants. This development highlights the importance of location.

Urbanisation and the favourable momentum in the economy have fuelled new-build construction. In the greater Helsinki area in particular, a large amount of office and retail space is due for completion, which will increase competition between shopping centres and office premises. Yet in spite of the economy's vigour, underutilisation of office space has remained relatively high, also in the Helsinki metropolitan area. Businesses' rapidly changing needs are no longer satisfied by old and difficult-to-reach premises.

One challenge for investors lies in converting existing properties ill-suited for office use into, say, residential dwellings. The returns on investment on properties in less desirable locations may not live up to the expectations set by high valuation levels.

Demand for retail space transformed by digitalisation and e-commerce

Digitalisation and e-commerce are transforming the how and where of trade. Market data reveal that the growth of e-commerce in Finland clearly accelerated in 2018.[8] Meanwhile, shopping centres have seen diminishing sales growth and declining visitor counts.[9] Consumers have especially increased their online purchases of clothing and related accessories. The ramifications for many shopping centres located outside the Helsinki metropolitan area are considerable.

The changing demand for office and retail properties has in part already resulted in investors increasing their investments in alternative property types, such as residential housing, care properties, and hotels.

The property market, which is in any case highly sensitive to the business cycle, is undergoing significant structural change, and this has increased the risks associated with investors and real-

estate finance. Urbanisation, changing consumer habits, and the growing prevalence of working from home all promise weaker returns-on-investment for office and commercial properties located in remote areas. Overly optimistic expected returns and less-than-desirable locations may prove problematic for investors and financiers alike.

Banks bear the risks of property investment finance

A significant proportion of property transactions are funded by owners' equity. At the same time, however, leverage remains a ubiquitous part of real-estate investing. The lion's share of credit used to finance property investment in Finland is still being issued by domestic banks as well as banks in the rest of the Nordics. The total volume of credit issued by domestic banks to the real-estate and construction sectors stood at EUR 48.5 billion at the end of 2018, which comprised 54.6% of banks' receivables from firms and housing corporations.

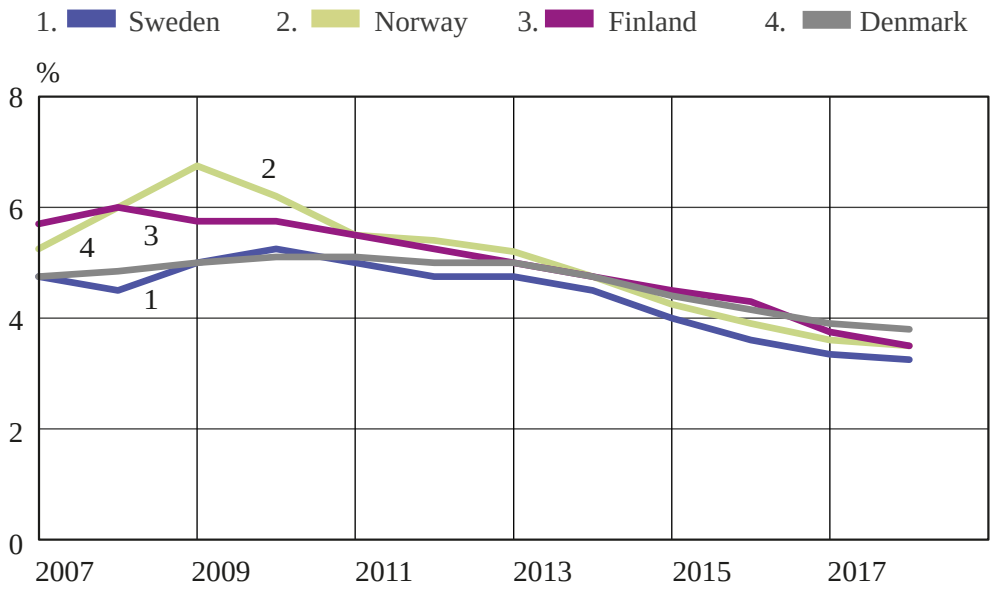
The number of loans issued by domestic banks that are exposed to real-estate risks has grown rapidly over the past two decades. Property company loans spurred this growth up until 2012. Since then, the momentum has been propped up by the number of loans issued to housing corporations. The stock of housing corporation loans has continued to grow by over 10% per annum for practically the entire past decade.

In recent years, Finnish entities have increased their uptake of market-based real-estate finance. At the end of 2018, large domestic construction companies as well as property rental and management firms accounted for 36% of all corporate bonds issued by domestic firms.

Banks' credit losses have largely been incurred from corporate lending. The annual credit loss incurred from corporate lending stood at over 5% relative to the loan stock during 1992–1994. Meanwhile, household loans defaulted at an annual rate of 0.9% relative to the loan stock during the same period. The relative volume of credit losses was much smaller in the aftermath of the financial crisis, i.e. 2008–2015. During this period, the corporate sector defaulted on credit worth EUR 250 million a year, on average. This represented less than 0.5% of the loan stock. Meanwhile, the household sector induced credit losses worth half this amount, or about EUR 125 million a year. Housing corporations scarcely defaulted on their loans at all.

Chart 2.

Low interest rates have depressed returns on commercial property



Source: Pangea/Mrec.

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Non-performing loans in the corporate sector stood at EUR 875 million, or about 1% of the loan stock, at the end of 2018. Businesses operating in real estate accounted for 27% of these loans. The largest share of non-performing loans can be found in the construction sector, at 2.9% of the loan stock. The real-estate sector has fewer non-performing loans than the average for all companies, at 0.8%. The risks of the real-estate sector and the industries it comprises are similarly reflected in loan rates, and the highest average interest rate on loans can be found within the construction sector.

The Nordics' large commercial property markets

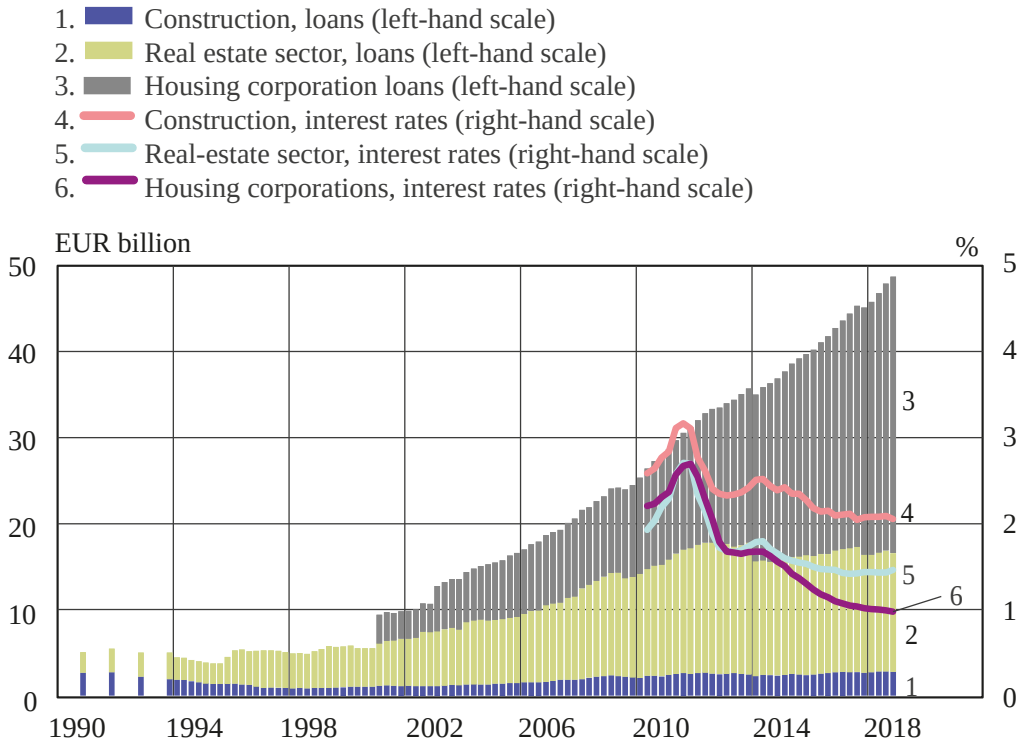
In Finland, as in the other Nordic countries, a great number of loans are related to real-estate activities. In fact, these loans represent a large proportion of the entire corporate loan stock (including loans to housing corporations). In Finland, this share is about half.[10]

Some of the debt taken out by housing corporations is attributed[11] to households. According to an

estimate by Statistics Finland, the share of these loans issued to households stood at EUR 20 billion in September 2018. This accounts for some 42% of all debt owed by companies (including housing corporations) operating in the real-estate sector. In Sweden, the country's financial supervisory authority Finansinspektion estimates that housing company loans account for about 15% of all corporate borrowing and about 28% of all corporate and housing corporation debt within the real-estate sector.[12]

Chart 3.

Domestic banks' real estate-related loan stock grown rapidly in past 20 years



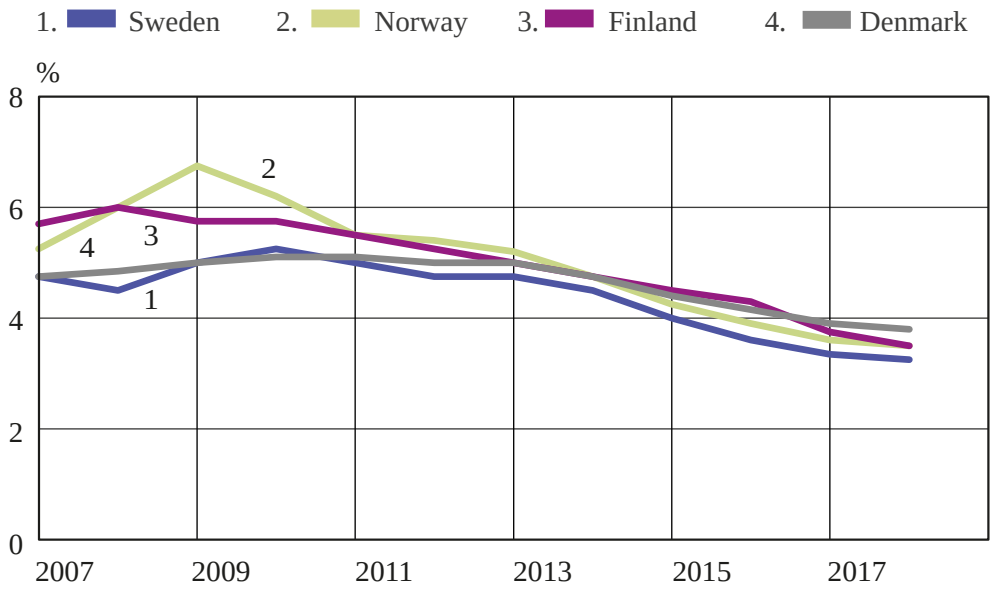
Sources: Bank of Finland and Statistics Finland.

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Investors have seen lower realised returns on commercial property investments across the Nordics, as investor demand has raised the prices of commercial properties throughout the region. Office buildings brought in returns of 3–4% in 2018. Commercial property investors' search for yield is evidenced in Denmark, for example, by growing foreign investor interest in properties located outside Copenhagen.

Chart 4.

Low interest rates have depressed returns on commercial property



Source: Pangea/Mrec.

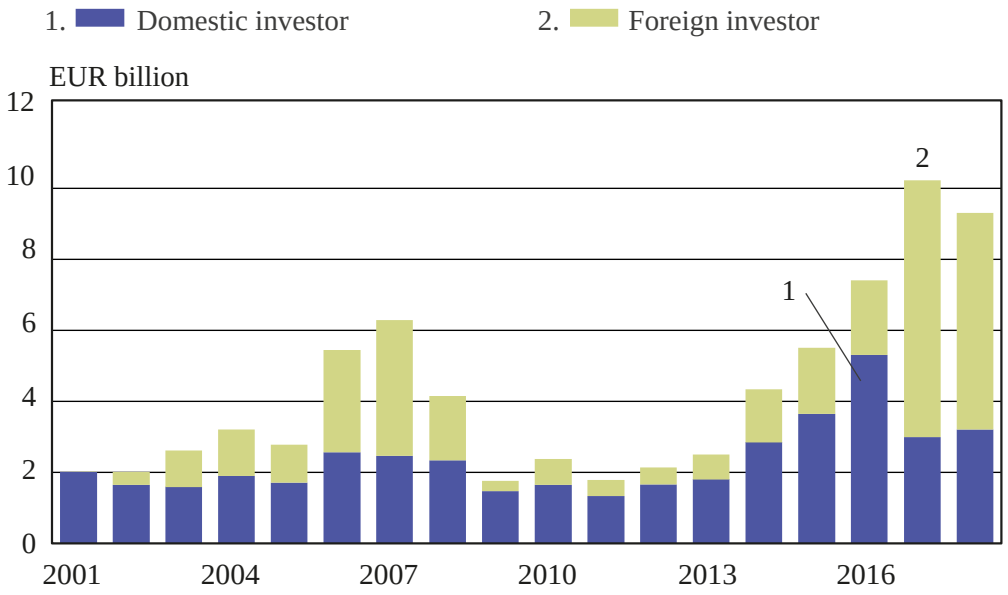
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Rent levels have also increased in all the Nordic capitals, although with clear differences. Over the past decade office building rents have increased by about 9% in Copenhagen, about 10% in Oslo and some 47% in Helsinki, while even reaching about 107% in Stockholm. Among other factors, the supply and demand of new office buildings has contributed to the rise in rents. However, regional divergences in rent growth can also be found within the countries themselves.[13]

In the Nordics, commercial property transaction volumes have persisted at a high level for four years now, and the total value of transactions has already surpassed its level before the financial crisis. Foreign investors are estimated to have accounted for some 40% of commercial property transactions in the Nordics in 2018. The share of foreign market participants was clearly lowest in Norway, at about 18%, and greatest in Finland, at about 66% of investors.

Chart 5.

Volume of major real estate transactions in Finland



Source: KTI Property Information Ltd.

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The funding of commercial property accounts for a considerable share of banks' corporate lending in each of the Nordics: about 50% in Sweden, 45% in Norway and 65% in Denmark. The entire Nordic banking sector is vulnerable to commercial real estate companies running into insolvency issues, triggered by, for example, rising interest rates or weakening economic conditions.[14] However, non-performing loans remain few and far between in the Nordic real estate sector, compared with other countries in the EU. In all the Nordics, such non-performing loans accounted for less than 0.8% of the loan stock in September 2018. The average for the EU countries was 6.4% during the same period.

In European comparison, the Swedish commercial property market is very large, at around 40% relative to GDP, compared with the EU-wide average of about 16%. The Swedish commercial property market has experienced a rapid rise in corporate debt in recent years.The loan stock contains, for example, bank loans and bonds issued by commercial property companies. Looking at the commercial property market as a whole – including both listed and privately owned companies – the stock of outstanding loans owed by Swedish commercial property companies has grown by up to 58% between year-end 2014 and the end of September 2018. The equivalent figures for

Finland, Denmark and Norway are 39%, 22%, and 6%, respectively.[15] Sweden's commercial property companies are in fairly good financial health, however, as their share of non-performing loans, for example, is extremely small.

Commercial property companies are increasingly turning towards market-based funding. In Sweden, for example, companies operating in the real-estate sector, including commercial property companies, have accounted for slightly over 40% of all corporate bonds issued in recent years. In 2018, 25% of the stock of loans owed by listed commercial property companies in Sweden was market-based.

Notes

1. Investors also value Finland's robust infrastructure, well-functioning rental market and low levels of political risk. ↑
2. While the volume of transactions declined by 9% from the historically high figures reached in 2017, 2018 was the second strongest year on record. ↑
3. KTI Property Information Ltd. ↑
4. The large corporate acquisitions of recent years, in particular, have contributed to this growth. ↑
5. Typically the so-called capitalisation rate, which the investor sets as a condition for investment. Yield is defined as the net operating income of a property (i.e. market rent after expenses) divided by the property's market value at the time of review. The lower the yield, the higher the property's valuation (relative to market rents at the moment of review), and vice versa. The yield can be viewed as the sum of the risk-free rate and risk premium, minus the presumed annual net rent growth percentage, plus the percentage of replacement costs of the capital invested. ↑
6. Prime real-estate generally refers to properties located in the most sought-after downtown areas. ↑
7. Foreign investor interest in peripheral countries not only depends on the outlook for growth and the balance of risks of these countries but also on the development of investment opportunities and expected returns in core countries. ↑
8. Euro-denominated sales increased by 41% year-on-year, see Vilkas Group: verkkokauppaindeksi. (Finnish only). ↑
9. Finnish Council of Shopping Centers. ↑
10. The real-estate sector's share is this large partly because of housing company loans. ↑
11. In addition to housing companies, housing corporations include all corporation forms of housing units. Repayment of housing company debt is effectively the responsibility of the households who own shares (i.e. dwellings) in the company. ↑
12. See https://www.fi.se/contentassets/86382ed610304769b77c5a35aa54891f/stability-financial-system-2018-2nn.pdf. ↑

13. In Norway's Stavanger, Bergen and Trondheim, for example, rents have remained at or even declined from 2013 levels. The rent levels in the capital cities are not directly comparable with each other, as rents may include various costs depending on the country and, for instance, property taxes. Nevertheless, Stockholm has the highest prices per square meter of all the Nordic capitals. ↑
14. Of the large Nordic banking groups, Danske Bank, DNB, SEB and Swedbank have commercial property lending listed as its own item in their loan portfolios. For these banks, commercial property finance accounted for between 16–31% of their total corporate loan portfolios at the end of 2018. At the end of 2018, Nordea's loans to the real-estate sector accounted for some 34% of its total corporate loan portfolio. However, this figure may include e.g. loans to residential property management companies, and is hence not fully comparable. ↑
15. The comparison only includes companies with balance sheet data covering the entire review period, i.e. from 2014 onwards. ↑

Keywords

Nordic countries, property investments, real estate market