The Finnish real estate investment market

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The Finnish real estate investment market has been exceptionally active in recent years. Sales volumes and market size have grown fast. By international comparison, the Finnish market is large in proportion to the size of the economy. Foreign investment has reduced required yields. Low required yields indicate the high valuation of real estate, especially in the very centre of Helsinki. This may expose the Finnish market to economic shocks from abroad. Risks in the real estate investment market reflect on banking particularly via lending.

The Finnish real estate investment market has been growing continuously, and in 2017 its value was estimated at EUR 64 billion, which is 28% of Finland's GDP. The Finnish market is in fact one of the largest in Europe relative to the size of the economy.[1]

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1. The estimate about the Finnish real estate investment market has been derived from real estate owned by professional investors. The definition also includes rental housing owned by professional investors, accounting for 29% of the entire market. Without the ownership of residential investors, the market accounts for 20% of GDP. Real estate owned by non-financial corporations and used by the owners are not included in this definition. The value of real estate used by the owners is about EUR 50 billion. Real estate owned by the public sector has been

Operating in the commercial property market requires plenty of capital, because it is based on a significant initial investment and gradual profit and value increase through rental income. The income component involves a great deal of uncertainty, depending on the economic cycle. Banks have typically financed real estate investors, and problems have emerged during weak economic conditions in the form of banks' increased volume of non-performing assets. Real estate owned by real estate investors is also generally used as collateral for debt financing. The collateral is often illiquid, which in a stress situation reduces the chances of realising it and getting the full price.

Not only real estate investment, but also construction of business premises may include financial stability vulnerabilities. Business construction, as construction in general, is very much dependent on the economic cycle. Building activity reacts to the prevailing rental and purchase price level and vacancy rates, because the most likely competitors are premises already on the market. Conditions may be very different once a building has been completed, owing to long construction times. Once the decision to build has been made, the market may change unfavourably for the builder. The expenses of a construction project are usually incurred early, with profit only coming into the picture in the later stages. As construction generally requires a lot of capital, the long timetables of construction projects make them more challenging in terms of financing. The risk management of business construction also depends on whether a business engages in new-build construction on its own behalf or as a contractor.[2]

Fewer new commercial properties to be built in 2018

In 2017, more new business construction projects were started than in 2016. New construction of retail and office properties was up sharply from 2016: shops by about 43% and office premises by 13%. In contrast, new industrial and warehouse construction projects were at about the same level in 2016 and 2017.

The Confederation of Finnish Construction Industries (CFCI) forecasts in spring 2018 that business construction will contract somewhat during 2018 with the exception of industrial and office construction. This is also evident from the smaller number of applications for building permits. CFCI nevertheless forecasts that the economic upswing will increase the number of new industrial construction projects, because owing to the structural change in the economy, industrial construction has already been at a historically low level for a prolonged period. On the other hand, warehouse construction is forecast to decline following active construction in recent years. Construction of shopping premises is expected to contract in 2018 by about 5%. Just like building construction in general, shop construction will also be focused on growth centres. According to the CFCI, 70–80% of all new office buildings will be built in the greater Helsinki area in places that have good public transport connections.

Foreign investors the largest owner group in the

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valued at around EUR 25 billion. Source: KTI.

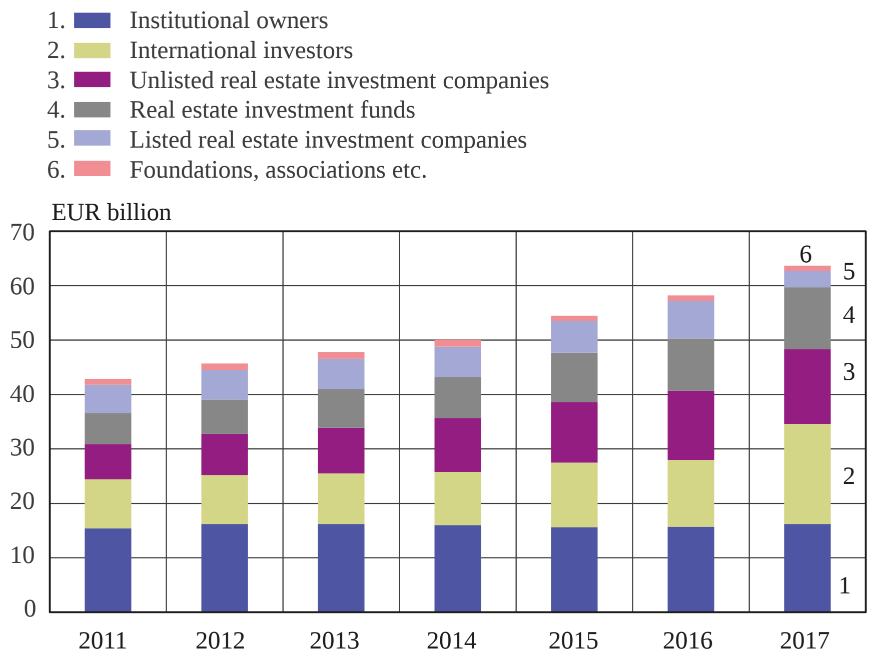
2. This means that the business itself is in charge of project planning, construction and rental/sale. When contracting out, the customer chooses a contractor to carry about the project against a contract price.

real estate investment market

Foreign investors became in 2017 the largest owner group on the Finnish real estate investment market, with a 29% share. The high number of foreign investors can be explained by what was for Finland a large individual sale, when Sponda sold its Finnish real estate portfolio to Blackstone for EUR 3.7 billion. As a result, foreign investors bypassed Finnish institutional investors, whose market share has been in an unbroken decline. Foreign investors have brought activity and liquidity onto the Finnish market. This has nevertheless increased the risk that foreign actors will retreat from the Finnish market in a stress situation, leading to lower prices. This could be a problem for those who used debt financing to invest in real estate and those who financed real estate investors, mainly the banks.

Chart 1

Size of the Finnish real estate investment market



Includes properties owned by professional investors.
Source: KTI Property Information Ltd.

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Of Finnish institutional investors, the employment pension institutions clearly have the largest real estate assets, but insurance companies also own a lot of real estate. In 2017, the employment pension institutions held real estate investments worth EUR 16.5 billion, of which 77% were in Finland.[3] The target with real estate investment is risk

3. Source: Finnish Pension Alliance TELA, https://www.tela.fi/en/investment_assets_trend.

diversification and protection against inflation, aiming for a steady income to cover long-term liabilities.

Investments by unlisted real estate investment companies have risen sharply in the 2010s, totalling EUR 13.7 billion in 2017. Unlisted companies have invested especially in rental housing. The investment stock of listed real estate investment companies, on the other hand, was more than halved as a result of the deal between Sponda and Blackstone.

The size of real estate funds under the supervision of the Financial Supervisory Authority was EUR 10 billion at the end of 2017. The majority of the assets in these funds are housing and real estate shares. Some 60% of real estate fund investments concern commercial properties, and about 40% homes. Moreover, investments in commercial properties have grown rapidly in recent years.

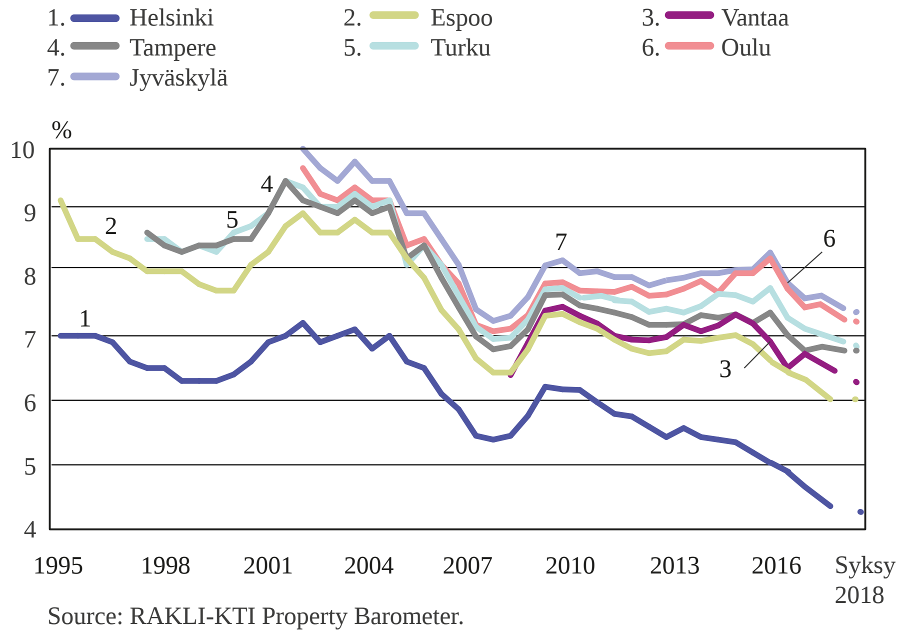
Major regional differences in real estate investment market

The Finnish real estate investment market is polarised, with large regional differences. Office rents are much higher in the Helsinki area and the required net yields lower than elsewhere in Finland. A rule of thumb is the smaller the required yield, the more valuable the real estate is. In Helsinki the required net yield is partly explained by strongly increased investments by foreign actors. Moreover, many domestic and foreign corporations with central functions have located in the Helsinki area, and those corporations need a lot of office space. Furthermore, a growing population adds to the need for retail properties. There are also big differences within the Helsinki area, and location is crucial. Especially within Helsinki itself, the rents and utilisation rates of prime offices are high. The required net yields on prime office premises in large cities have notably decreased in recent years. The required net yields on prime offices in Helsinki city centre, for example, have fallen to a level of just over 4%. Elsewhere in the Helsinki area, too, and in Tampere and Turku, required net yields have decreased, but are still 6–7%. The current historically low risk-free interest rate can partly explain why required yields have decreased.[4]

Chart 2

4. The investment target's required yield consists of the risk-free interest rate and the investment target's risk premium.

Prime office yields in major Finnish cities



Source: RAKLI-KTI Property Barometer.

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Retailing changes affect business premises

The rapid growth of online shopping has challenged traditional operating models in the retail trade, which has clearly been reflected in the expectations of traders operating from shopping centres.[5] According to the Shopping Centre Barometer, web stores and online buying has a negative impact on the operation of shopping centres and department stores. As a result, shops are expected to become smaller, and other premises larger. The question is whether there will be enough customers for the shopping centres.

The efficiency of office premises has already been increased. The current trend is that there are fewer square metres per employee. More and more people work in open-plan offices instead of having their own room, and coworking spaces are increasing in popularity. The adaptability of office premises is also an important consideration, and the location of offices outside the city centre has to be carefully scrutinized. For example, in the State sector, the Government has decided that only the ministry offices will remain in the centre of Helsinki. The vacancy rate of offices in the Helsinki region has risen, standing at 13.4% in 2017. This is a high figure by international comparison. In Helsinki city centre, however, the vacancy rate is much lower (7.8% at the end of 2017). The high vacancy rate is also explained by the construction of new premises.

Demand for accommodation has increased, which is shown in hotel occupancy rates and

5. Shopping Centre Barometer.

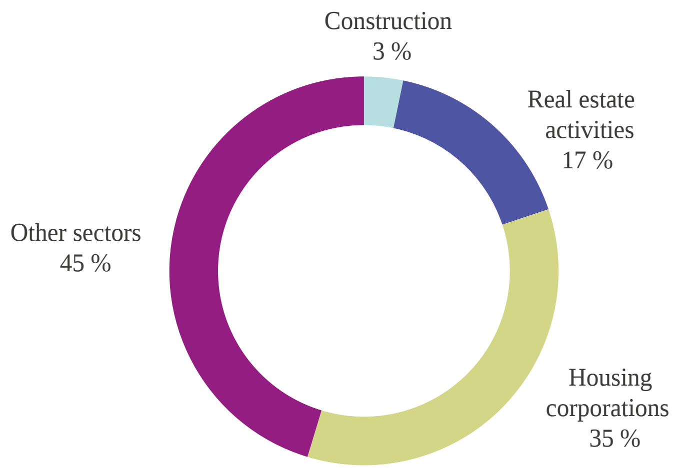
the number of overnight stays. Hotel capacity may also be increased by changes of use for existing real estate. An office block, for example, can be converted into a hotel or homes.

Finnish banking sector exposed to real estate investment market risks, particularly through lending

Real estate market risks feed through to the banking sector via lending. Operation on this market requires plentiful financing, which results in large volumes of loans in proportion to the significance in terms of the national economy. Construction and real estate activities account for a large proportion of banks' corporate loan stock. More than half of non-financial corporations and housing corporation loans are related to these sectors. The majority of the loan stock in these sectors concerns housing corporation loans.

Chart 3

More than half of the corporate loan stock concerns construction and real estate activities



Source: Bank of Finland.

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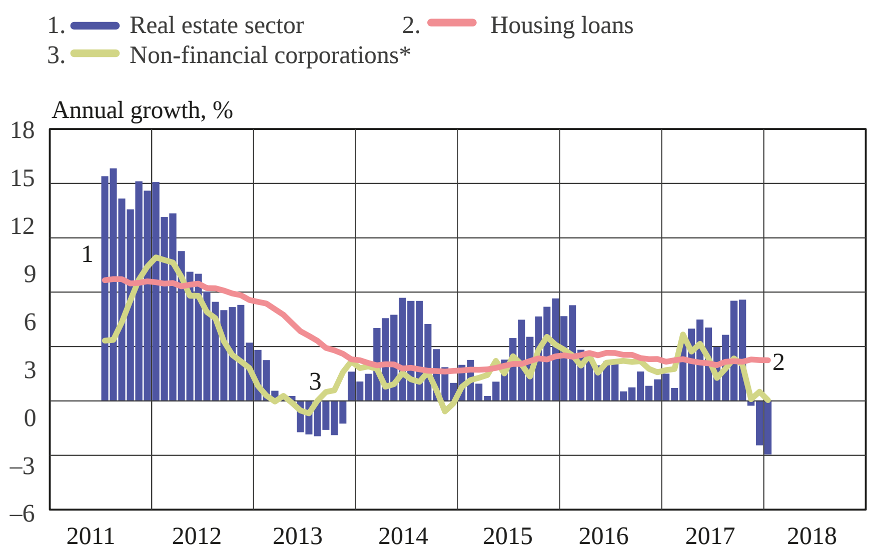
Methodology
The classification of industrial sectors does not fully specify the business conducted in any given premises. However, we can identify two sectors that are closely linked to real estate markets.
1) The main category of real estate activities includes sale or purchase of real estate, real estate rental and other real estate services, such as real estate assessment. Real estate services may concern one's own or leased real estate and may be carried out under a commission or contract. This main category also contains housing management operations.
2) The main category of construction includes housing construction, civil engineering and specialised construction.

It is also useful to divide real estate activities by means of sectors into non-financial corporations and housing corporations. This allows us to exclude housing corporations from any analyses concentrating on business premises.
From the viewpoint of national accounts data, real estate activities covered 62% of companies' ownership of commercial real estate ownership in 2016. The remaining ownership of business premises by companies is excluded from the scope of an analysis focused on real estate operations and construction.

Even without housing corporation loans, a significant proportion of banks' corporate loan stock falls under the category of real estate activities and construction. The loan stock of these sectors totalled EUR 16.3 billion in January 2018, accounting for 30% of corporate loans. Between July 2010 and January 2018, the average annual loan stock growth of real estate activities was 3.7%, and that of construction was 3.5%. By comparison, the growth rate of households' housing loan stock was 3.4%, and that of corporate loans 3.0%. The annual growth of sectors susceptible to real estate risks has been somewhat higher than the average for corporate loans during the current decade. Real estate activities and all corporate loans have followed similar trends since 2015. Individual observations help to explain the lower volume of loans for real estate in recent months.

Chart 4

Real estate sector loan stock increased faster than other corporate loans and housing loans in current decade



*Excl. repos.
Source: Bank of Finland.

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Owing to the capital-intensive nature of these sectors, it is particularly important to pay attention to the risks associated with lending to them. Banks evaluate credit risks and factor these into loan interest rates. The cyclical nature of the construction sector is factored into the loan interest rates, while real estate interest rates do not reflect this risk: the construction industry's loan stock interest rate was 2.13%, and that of the real estate industry 1.46% at the end of 2017. Corporate interest falls between the two, at 1.64%.

The higher interest rate for construction is explained by a number of factors. The strongly cyclical nature of construction is reflected in liquidity problems, with the risk of bankruptcy much higher than in many other industries. In the early years of the new millennium, 0.9-1.5% of companies in the construction industry went bankrupt each year, reaching a peak during the recession in 2008–2014. There were considerably fewer bankruptcies in the real estate activities: about 0.2–0.4% of companies.

Loan risks are affected not only by the cyclical nature of the industry, but also by loan collateral and repayment periods. The percentage of covered loans in construction is lower than in the real estate sector but at the same level as corporate loans on average, i.e. slightly more than 40% of loans in 2011–2017. Within real estate, the percentage of covered loans in the loan stock has risen sharply, standing at almost 70% in December 2017.

Loan repayment periods vary considerably, but the average period can be used to assess the trend. However, we cannot compare repayment periods between the industries, because they have such different structures. In real estate activities, the repayment period of new loans lengthened somewhat, by 1.2 years in the current decade, being 9.3 years in December 2017. The repayment periods for construction loans has been 2.8–5.2 years.

Conclusion

The strong interest among especially foreign investors in the Finnish real estate investment market has increased the size of the market and reduced required yields. The size of the Finnish market in proportion to GDP is one of the highest in the EU. No comprehensive price index is available of the business premises market, but historically low required yields indicate high prices. However, the market is polarised, and less attractive properties suffer from underutilisation. The large proportion of foreign ownership of the real estate market may be a channel through which foreign financial shocks can make themselves felt on the Finnish real estate market and perhaps the entire national economy. Risks to the Finnish real estate market are channelled to banking operations particularly through lending. The percentage of corporate loans that were closely linked to the real estate market was also considerable, at about 30%. Building industry companies pay higher interest on their loans owing to, for example, the cyclical nature of the industry and the higher bankruptcy risk than in other industries. Interest paid by real estate businesses are on average lower than corporate loan interest, because they have on average more collateral and the bankruptcy risk is also lower.

Tags

banks, business premises, commercial property, financing, real estate investment market