THE INVESTMENT MARKET

AUTUMN 2024

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The market defies interest rates: Are higher rents being priced in?

Declining interest rates over the summer, combined with relatively low concerns about the likelihood of a hard economic landing, have sparked gradual optimism in the transaction market. Several transactions indicate that yields have ***declined somewhat*** during the summer months, particularly for secondary properties, where yields initially widened the most during the peak of market stress.

Our prime yield estimate remains, **with some caution, unchanged at 4.75 percent,** though this level is also under pressure. This optimism persists despite recent interest rate developments. **The latest signals from the market suggest a slight downward trend even in the prime segment.**

Looking at the recent development in interest rates, it's clear that the market and interest rates are pulling in opposite directions:

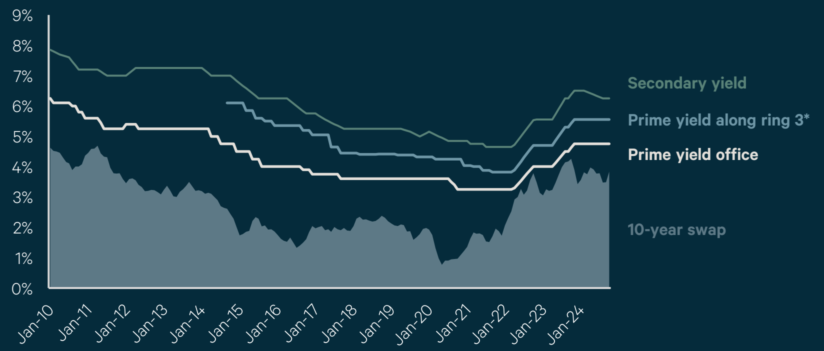
- Prime yield is currently **at the lower end relative to interest rates.**
- The 10-year swap rate could naturally fall a few dozen basis points after recent increases**, but in such a case, we'd see a normalized yield gap rather than a high one.** We also can't rule out the opposite scenario, where rates increase from their current levels.

To simplify: Property yields have not increased as much as interest rates alone would suggest, meaning the market had already accounted for lower future rates (as seen in the summer). Now, after the latest rise in rates, the market seems to be defying these trends.

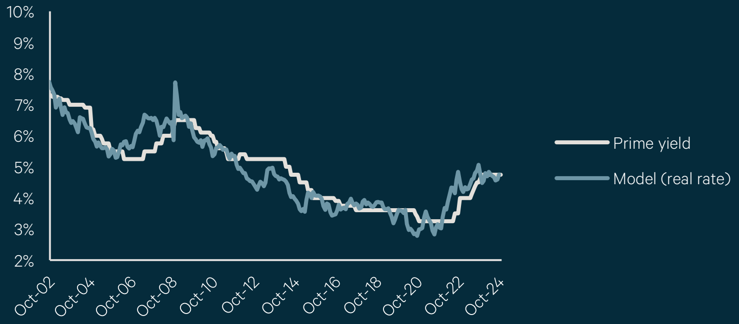
Simultaneously: If the market expects solid income growth over time, this could help keep yields low today. This may be exactly what's happening now, with higher rents potentially being priced in. The relationship between interest rates and property values, however, remains complex, as explored further in this guest commentary in *Kapital*.

While it seems like the market is pricing yields slightly downward, **our long-term real interest rate model suggests that a prime yield of 4.75 percent is very close to a long-term equilibrium and fair value.**

Yields vs. interest rates



Model based on real rate vs. prime yield office Oslo



Source: UNION, Macrobond, DNB Markets *Average across multiple areas

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Pricing relative to other asset classes and countries

In the commercial real estate market, the most common metric for relative pricing is a comparison with the risk-free interest rate. However, for some investors it may also **be useful to consider how property prices compare with asset classes like stocks or real estate investments in other countries.**

In the top-right graph, we compare the earnings yield of U.S. stocks and the office yield in Oslo against U.S. 10-year real interest rate. Since the dot-com crash, the average risk premium for U.S. stocks has been 5.4 percentage points (relative to the real interest rate), while for office property in Oslo, it averaged 4.0 percentage points over the same period. **Currently, the levels are almost identical, around 2.7 to 2.9 percentage points.**

This could, in principle, be justified if robust earnings growth is expected. Yet, from this simple perspective, **both seem slightly overvalued, particularly U.S. stocks.**

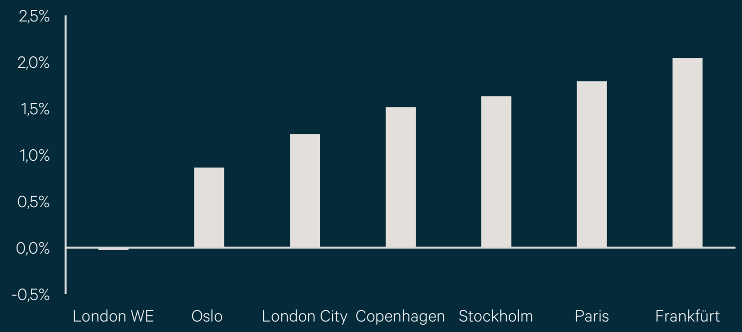
When considering interest rate levels, property yields in Norway are relatively low compared to most other markets. For example, in Sweden, the 10-year swap rate is currently at 2.47 percent, while the prime yield is just above four percent.

The difference in real estate pricing across various cities and countries **is largely due to varying expectations of future earnings growth and leasing market development.**

A reasonable interpretation of both graphs is that they **illustrate how risk assets are sharply priced relative to interest rates, particularly in markets where investors expect strong income growth.**

Risk premium relative to U.S. real interest rates: S&P 500 vs. Prime office Oslo

Yield gap: Prime yield office minus 10-year swap



Source: UNION, Macrobond, FactSet, JLL

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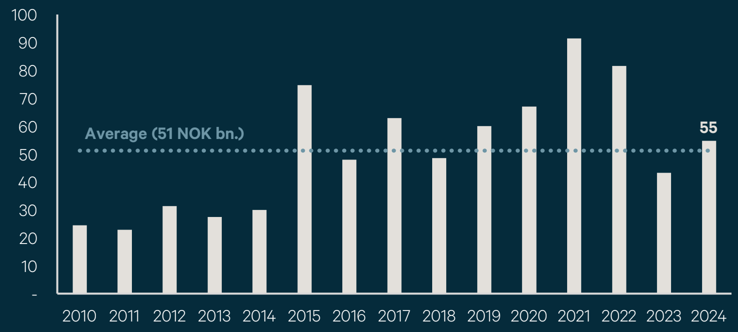
Increasing transaction volume from a low level

In the first three quarters of this year, we have recorded a transaction volume of NOK 55 billion, marking an increase of nearly 30 percent compared to the same period last year. This rise in activity has been driven by several factors:

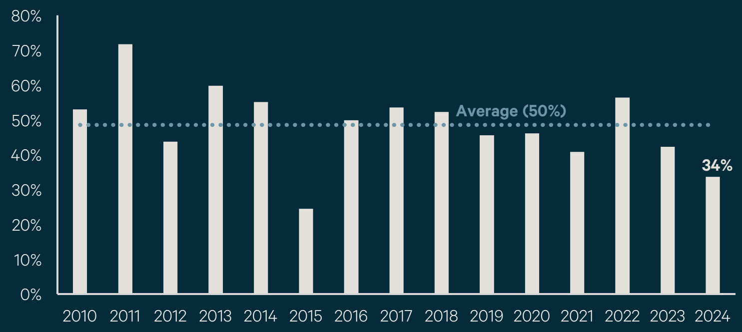
- **Improved financing conditions** in both the bank and bond markets, coupled with declining interest rates, at least until recently.
- **Stable yields** over an extended period
- **A low probability for recession** and increased confidence in the leasing market
- **Sellers needing to take action** due to refinancing requirements or to strengthen their balance sheets

So far this year, large transactions have primarily driven this volume. Deals under NOK 500 million constitute approximately 34 percent of the total transaction volume—the lowest since 2015, a year marked by a high number of substantial transactions.

Transaction volume Q1-Q3 (NOK bn.)



Share of transaction volume under MNOK 500



Source: UNION

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Comeback for offices

Following two years of declining office transactions as a share of the market, **office assets have made a strong comeback this year,** largely due to large-scale deals. Since 2010, transactions above NOK 1 billion have typically represented around 30 percent of office volume, **whereas in the current year, approximately 75 percent of transaction volume has been driven by billion-kroner deals.** Notably, at least 85 percent of these major transactions have been triggered by refinancing needs or balance sheet strengthening.

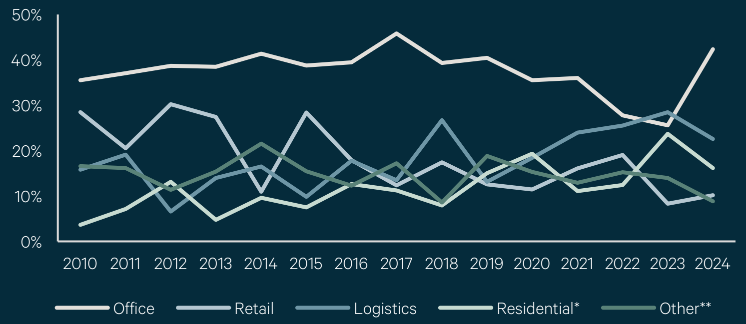
In recent years, raising equity for new property projects has been highly challenging, as evidenced by **syndicate groups becoming net property sellers since December 2023** (on a 12-month rolling basis). This shift is less about extensive selling and more about the absence of new acquisitions. However, there are signs that the market for club deals might have bottomed out, **with more properties syndicated already this year than in all of last year.**

While syndicates have not sold at historically high levels over the past two years, it's essential to note the change in sale motives for. Where syndicates previously "flipped" properties for profit, many of **today's sales arise from refinancing difficulties.**

In the absence of syndicate players as liquidity drivers, other players have stepped in.

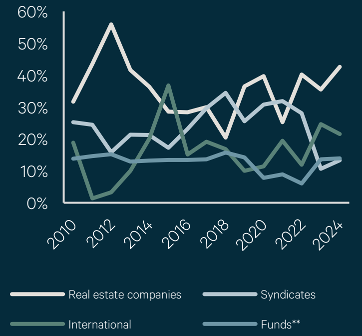
- **Norwegian property companies have captured the largest market share this year, approximately 43 percent.** Notably, the two largest transactions—Reitan's acquisition of Entra's Trondheim portfolio and NPRO's acquisition of Martin Linges vei 33—comprise around 40 percent of this volume.
- **Similar to 2023, international investors continue to hold a considerable portion of the Norwegian transaction market, representing about 22 percent.** These foreign buyers have focused primarily on logistics and residential assets in recent months.

Share of transaction volume



Net acquisition syndicates (NOK bn. – 12-month rolling)

Share of transaction volume by type of buyer



Source: UNION *Including residential development **Including hotels
**Including pension funds

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More sales likely on the horizon …

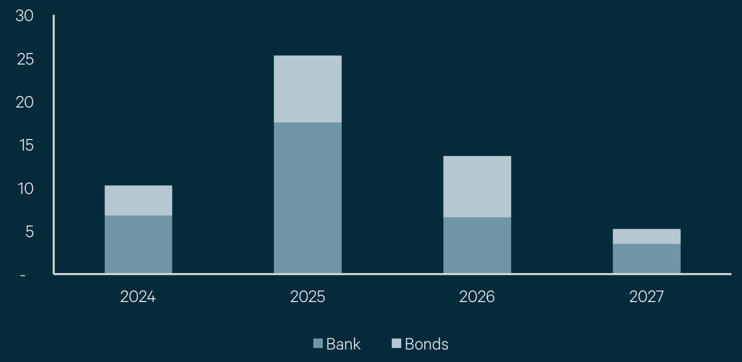
Market sentiment is clearly improving, and the risk of a debt crisis appears minimal. However, this doesn't change the fact that many still feel the pressure of high interest rates.

Several factors are likely to **trigger more property sales in the near future:**

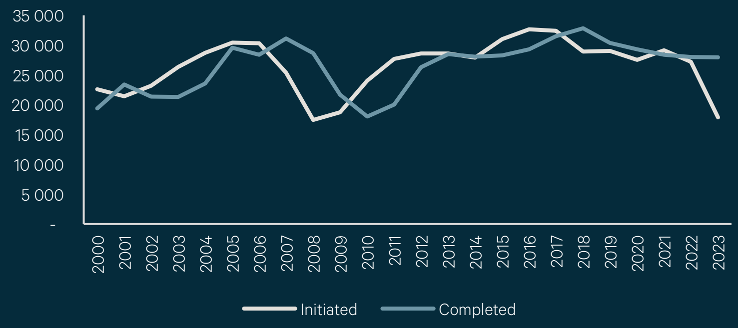
- **Upcoming Debt Maturities:** There is still significant debt volumes maturing in 2025 and 2026, especially within syndicated properties.
- **Increasing Interest Expenses:** Even as interest rates and bank margins decrease, average interest costs in many property portfolios and SPVs are set to rise. Older, more favorable fixed-rate agreements will eventually be replaced with new, higher-rate ones, even if rates soften from their current levels.
- **Low Loan-to-Value (LTV) Ratios:** Although banks are gradually easing their lending conditions, they remain conservative. Lower property values and LTV ratios will still create a "funding gap" that needs to be filled via equity raises, property sales, or alternative funding sources.
- **Increased Investment Needs:** Many portfolios face substantial investment demands in the years ahead. Rising construction and adaptation costs, as well as ESG and taxonomy requirements, are adding to this pressure. Financing these investments through debt is likely to become more challenging, pushing more owners to seek capital from other sources.
- **Lagged Project Completions:** Following the downturn in initiated housing projects in 2008, it took two years for housing completions to reach their lowest point, only normalizing by 2012. A similar trend is unfolding now, with significantly fewer housing completions anticipated in 2025 and 2026 due to the lack of new housing project initiations in recent years. This will impact the liquidity of residential developers.

Lastly, some players, such as funds with limited lifespans, have postponed sales over the past few years, awaiting a better market sentiment.

Debt maturities in club deals (NOK bn.)*



Number of initiated and completed housing units



Source: UNION, SSB. *Some of the volume has already been refinanced, especially the amounts maturing in 2024 and early 2025.

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… While others may be ready to buy

The real estate market’s value decline, coupled with a rising stock market, **has shifted the allocation weightings in many portfolios,** especially among institutional investors.

At the start of 2021, Norwegian pension companies held an approximate **10 percent real estate allocation within their assets under management (AUM),** including fund investments. Given changes in both total AUM and real estate market values, **this weighting has likely decreased to about 7.5 percent,** excluding any newly injected capital. To return to the 2021 allocation levels, approximately NOK 12.9 billion would need to be reallocated to real estate.

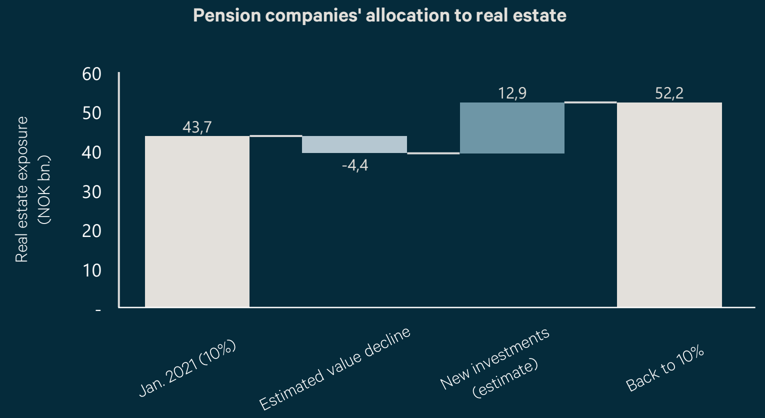
Preliminary estimates suggest that roughly half of this amount has already been invested since 2021, **leaving an additional NOK 6–7 billion** needed to bring real estate back to 10 percent of the managed portfolio. Much of this target capital is already committed to funds with dry powder ready for deployment**.**

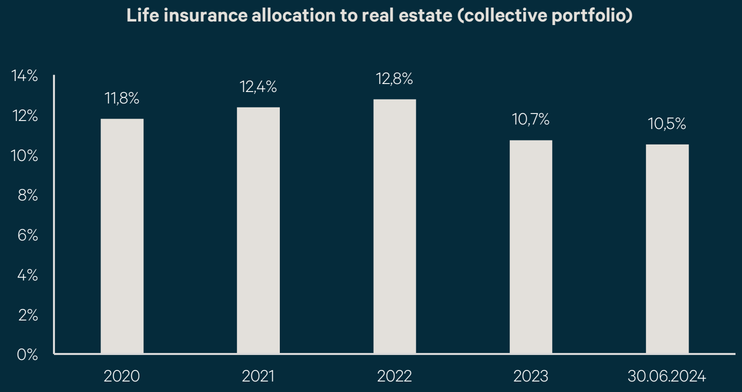
A similar trend exists among Norwegian life insurance companies, which had an average real estate allocation of 10.5 percent in the collective portfolio as of mid-2023. Comparatively, their allocation peaked at 12.8 percent in 2022 and stood at 11.8 percent in 2020. **If these companies aim to return to 2020 levels, an additional NOK 18 billion in real estate exposure would be necessary.**

Of course, there is no fixed rule requiring a return to previous allocations, and the peak weighting may have been somewhat elevated within the market cycle. **However, it’s reasonable to expect that the unleveraged portion of the market—largely comprised of pension companies and life insurance companies—will maintain strong purchasing power going forward.** This aligns well with current trends observed in the transactions market.

Additionally, other well-capitalized buyer groups include:

- **Large, family-owned property companies** with robust balance sheets
- **Norwegian, Nordic, and international funds** with dry powder ready for strategic purchases
- **Investors** with high earnings in other sectors, such as seafood and shipping





Source: Finanstilsynet, SSB. UNION (further calculations)

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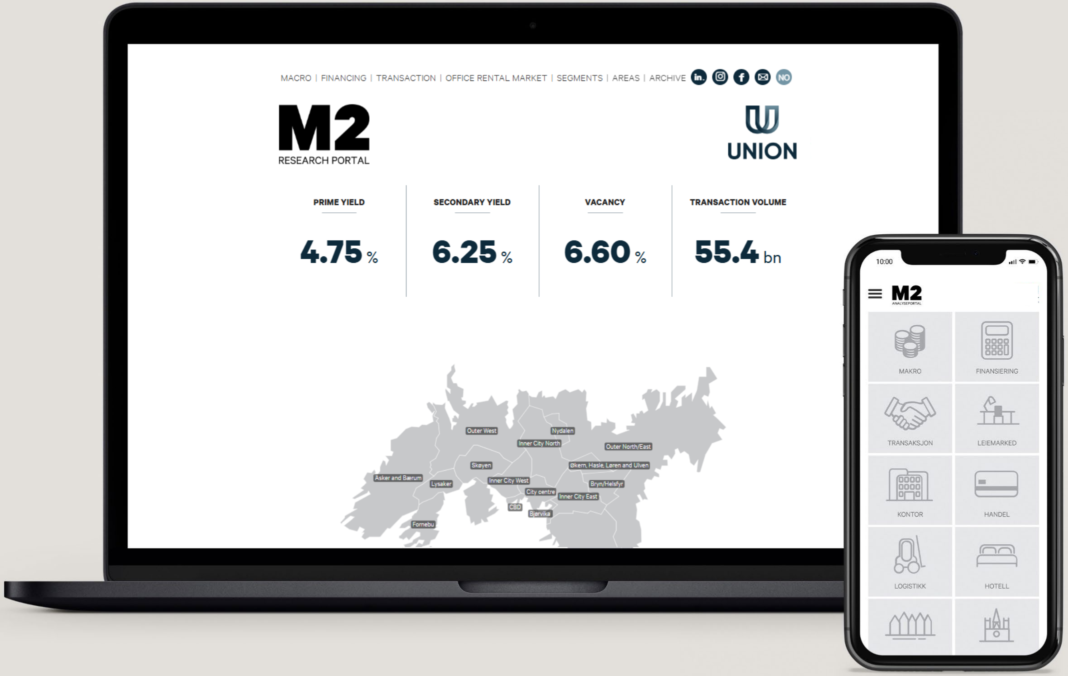

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