January 2023

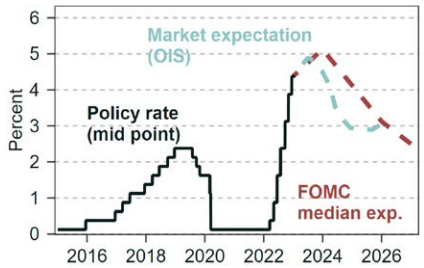
Light at the end of the tunnel

Macro Insights

Reduced uncertainty

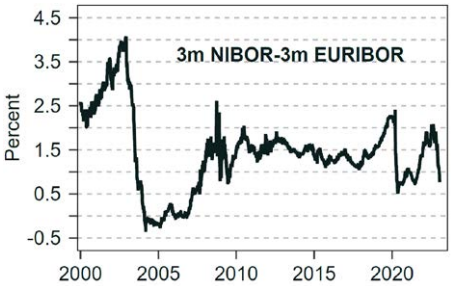
- After increasing sharply, policy rates in Norway, the US and the eurozone are expected to peak by summer. How fast interest rates will come down again is uncertain, and the market seems to believe in a faster deceleration than the central banks.
- Ahead, we expect reduced uncertainty regarding interest rates and corporate earnings to boost liquidity in the credit markets
- For the first time ever, the policy rate in Norway is expected to be lower than the policy rate in the eurozone, and this favourable development in interest rate differential might make it more interesting for euro based investors to look to Norway.

US: policy rate nearing its peak



Source: Macrobond

More favourable interest rate differential



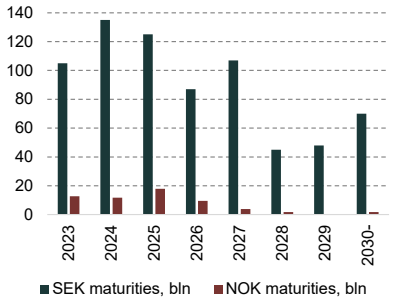
Source: Macrobond

Commercial Real Estate

Liquidity returns

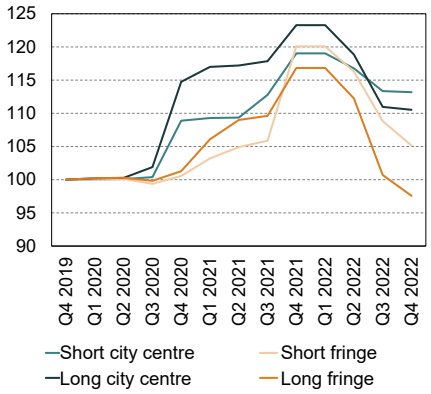
- Last year ended with significant uncertainty and low liquidity in the Norwegian transaction market. However, we expect liquidity to gradually improve as we move towards summer.
- We are keeping our yield estimates unchanged but do expect them to rise slightly in the times ahead.
- Nordic real estate bonds worth NOK 250 billion matures within the next 18 months, the majority in Sweden. This can reduce the proportion of Swedish investors in the Norwegian market this year.
- However, activity from euro-based investors could increase as a result of a more favourable interest rate differential.

Wall of refinancing among Nordic bonds



Source: Nordic Trustee / Stamdata

Flattening property values



Source: JLL, Akershus Eiendom

Macro | Reduced uncertainty

Central banks in the US and Europe have tightened their monetary policies considerably, and policy rates have risen at a pace not seen since the 1990s. Yet the central banks are predicting a soft landing in the eurozone, US and Norway this year. In the interest rate markets, meanwhile, inverted yield curves indicate that recession fears are lingering.

Policy rates have in any case reached levels which are prompting the central banks to suggest that the end of the hiking cycle is near, while the interest rate markets are pricing in a peak in policy rates before the summer. The next question is therefore when interest rates will come down again. The central banks predict that it will take time, but the market pricing suggests that policy rates in the US and Norway may be cut again as early as this year. Both short and long-term interest rates are likely to fall from their current levels, but it is still important to note that they will probably end up higher than we have seen in the last couple of years.

Norwegian interest rates have been higher than in the eurozone over the past two decades, something which may have prevented euro-based investors from acquiring property in Norway. The differential between interbank rates in Norway and the eurozone has fallen sharply, however, and the policy rate in the eurozone is expected to be higher than in Norway, something which has never happened before. This will make it more interesting than ever for euro-based investors to invest in assets in Norway.

During the first six months we expect increasing clarity around the future of both interest rates and corporate earnings. Reduced uncertainty should help lower credit spreads in the financial markets, thus boosting liquidity in the commercial property market. The coming months are likely to be tough, but as summer approaches we expect to begin to see the light at the end of the tunnel.

Capital Market | Liquidity returns

Last year ended with significant uncertainty and low liquidity in the Norwegian transaction market. Although the number of transactions has remained relatively high, the overall volume is down 44 per cent from the 2021 peak. Ongoing processes demonstrate a desire to buy amongst investors, but access to credit in both the banking and bond markets is challenging and will be crucial for liquidity in the immediate future.

The key question is when sentiment will turn and market liquidity return.

Looking at the Nordic bond market, bonds worth around NOK 750 billion have been issued to Nordic property companies, of which around NOK 250 billion will reach maturity over the next 18 months. In Norway, bonds make up only 15 per cent of all credit, and only NOK 25 billion will reach maturity in the next two years. The refinancing risk is therefore significantly lower than in Sweden, where 40 per cent of credit is issued in the bond market.

We expect that the proportion of Swedish investors in the Norwegian transaction market could fall in the next few years. Although we may see increasing interest from euro-based investors. Within the next six months we expect the policy rate in the eurozone to outstrip that in Norway. This has never happened before and could lead to increased activity among euro-based investors as it would cut hedging costs and otherwise create a more balanced yield gap. We are keeping our yield estimates for commercial property unchanged for the time being but do expect them to rise slightly in the times ahead. There is a large amount of capital in search of good property investments, and the most attractive investment cases are likely to continue to generate healthy interest.

Interest rates in Norway, the US and the eurozone are expected to peak in the first six month of the year, which could help reduce uncertainty and thus stimulate liquidity in the market leading up to the summer. With a more predictable economy, the market is likely to rebound, although the risk in terms of property values remains on the downside.

Reduced uncertainty

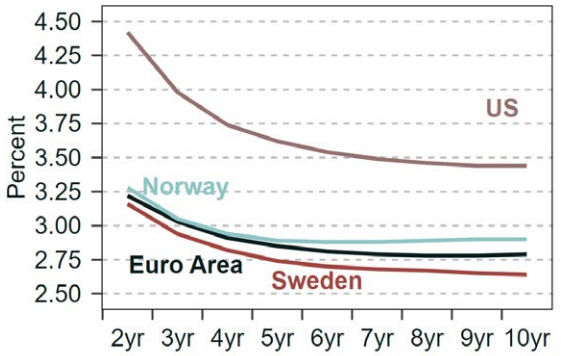
by Kari Due-Andresen, Chief Economist and Head of Research - Akershus Eiendom

Rapidly rising interest rates and credit spreads continued to dog the asset markets last year. However, policy rates are predicted to peak in Norway, the eurozone and the US before the summer, and we expect greater clarity around interest rates and corporate earnings to boost liquidity in the credit markets this spring. Positive trends when it comes to interest rate differentials could also make investing in Norway more attractive for euro-based investors than has been the case for quite some time.

Policy rates are nearing their peak

As a result of accelerating inflation, central banks in the US and Europe have tightened their monetary policies considerably. Policy rates have been raised at a pace not seen since the 1990s. Changes in interest rates affect economic development with a time lag of some 1–3 years, and due to the speed of the rate increases, we have yet to see the full effect. Various sentiment surveys show that Norwegian households and those of our trading partners are very concerned about the immediate future. These expectations stand in stark contrast to forecasts issued by the central banks implying a soft landing in the eurozone, US and Norway this year. Pricing in the interest rate market indicate that investors are more pessimistic, with inverted yield curves suggesting lingering recession fears for Norway, the eurozone and the US.

Figure 1: Swap rates



Source: Macrobond

Consumer prices have risen to levels not seen in Norway and amongst our Western trading partners since the 1980s. Yet it appears that inflation in many countries, including Norway, has peaked and is now falling. The only question is how quickly. The central banks expect inflation to remain stubbornly high, which also means that it will take time before the policy rate comes down.

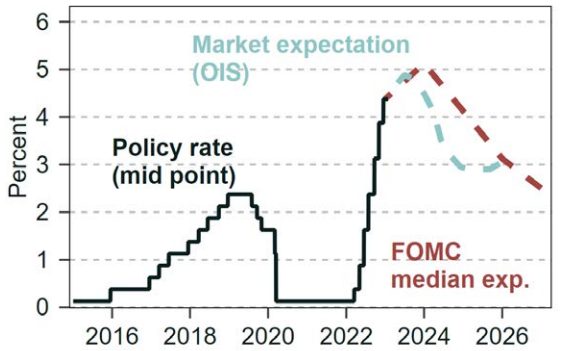
Figure 2: CPI, Norway vs trading partners

Source: Macrobond

Policy rates have in any case reached levels which are prompting the central banks to suggest that the end of the hiking cycle is near. The interest rate market is pricing in a peak in the Norwegian policy rate in March, while policy rates in the US and the eurozone are expected to climax in June and July, respectively. The next question is therefore when interest rates will come down again. The central banks predict that it will take time to rein in inflation and therefore more time before they can cut interest rates

again. Market players in the US do not believe what they are being told by the Fed and have priced in an interest rate cut later this year. Who is right will probably become clearer in the coming months.

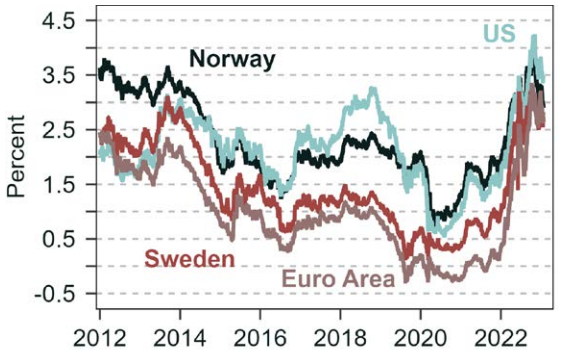
Figure 3: US: Policy rate



Source: Macrobond

While short-term market rates in Norway closely mirror the monetary policy of Norge's Bank, long-term rates depend on the global economy and have reflected US long-term rates fairly consistently since the pandemic. Long-term rates have fallen slightly from their October peak, partly due to signs of reduced price pressure in the US. If the US were to enter a recession this year, long-term interest rates are likely to fall further.

Figure 4: 10 year swap-rates



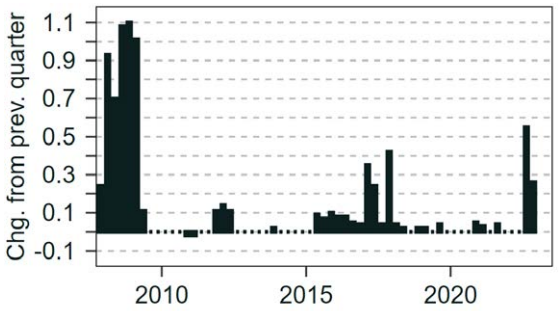
Source: Macrobond

However, it is worth bearing in mind that even though interest rates are likely to come down from where they are today, they are still expected to end up higher than what we have been used to in the past 2–3 years.

Likely boost for the credit markets

Considerable uncertainty around interest rates and corporate earnings fuelled an increasingly challenging lending market over the past year. Bond financing in both Norway and Sweden became increasingly expensive during the year and all but inaccessible to property investors. The cost of bank loans has also increased as the banks face rising borrowing costs. According to a lending survey by Norges Bank, the banks have tightened their lending conditions as a result of growing uncertainty around corporate earnings. They have introduced more rigorous criteria for equity capital, amongst other things.

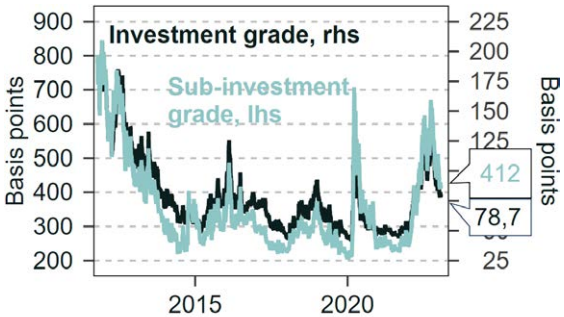
Figure 5: Loan conditions - equity cap. requirement



Source: Macrobond

Despite a continued challenging financing climate, the European market for corporate bonds has recently seen a reduction in credit spreads compared with the extreme levels of Q4 last year. Some of this is likely to be down to a warmer winter and the reduced risk of energy rationing and bankruptcies amongst European companies.

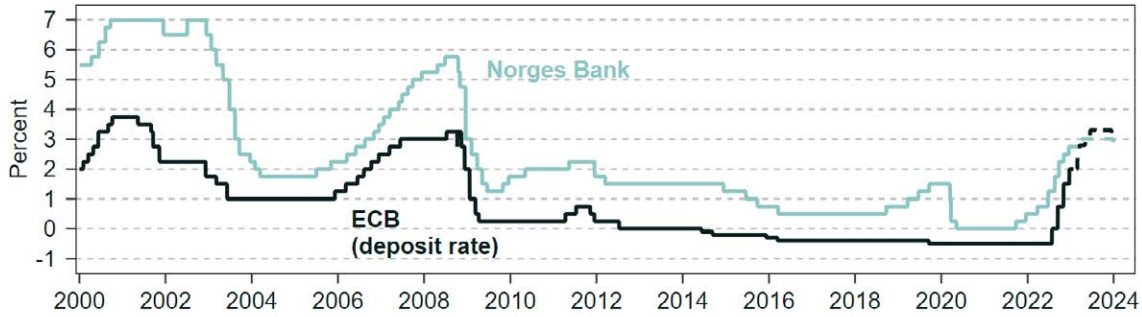
Figure 6: Credit spreads, 5yr generic CDS, Europe (ITRAXX)



Source: Macrobond

Ahead we expect further clarification around the real economy, inflation and interest rates to help bolster the credit markets in both Europe and the Nordic region.

Figure 7: Policy rates, incl. market expectations*

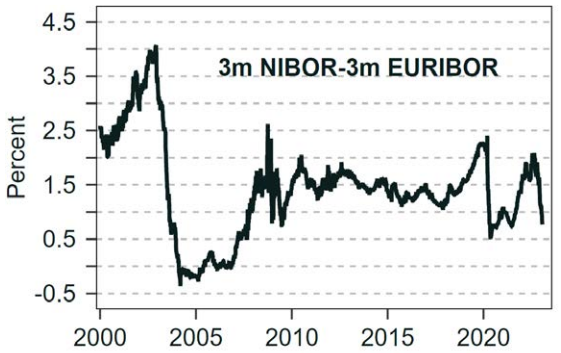


Source: Macrobond and Bloomberg
* market exp. based on FRA and OIS rates

More attractive for euro-based investors

Norwegian interest rates have been higher than in the eurozone over the past two decades, something which may have prevented euro-based investors from acquiring property in Norway. Except for during the early stages of the pandemic, the differential between interbank rates in Norway and in the eurozone is now lower than it has been for a long time and is expected to narrow even further during 2023.

Figure 8: Interest rate differential, Norway vs Euro Area



Source: Macrobond

The interest rate markets have in fact priced in a higher policy rate in the eurozone than in Norway for Q2 this year, which has never happened before (Bloomberg, FRA vs. OIS). This might boost incentives for euro-based investors to consider real estate in Norway.

If international investors are to invest in Norway, they must decide whether to hedge against currency risks. The benefits of forex hedging are greater the higher the volatility of the currency pair. For example, there is much higher volatility in the EUR/NOK pair than in SEK/NOK.

Figure 9: Exchange rates, EUR/NOK and SEK/NOK

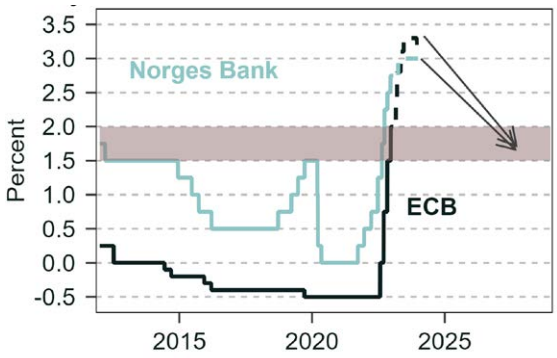
Source: Macrobond

For that reason it is also much more relevant for euro-based investors than Swedish investors to hedge their investments in Norway.

Currency hedging comes at a cost, primarily driven by the interest rate differential between the currencies in question. For instance, currency hedging becomes more expensive for a euro-based investor the higher the Norwegian interest rate versus the eurozone rate. For a euro-based investor investing in Norway, the cost of currency hedging is lower than it has been for a long while and will probably continue to fall if the eurozone policy rate overtakes the Norwegian policy rate during the first six months of the year.

With currency hedging in mind, it is therefore more attractive than ever for euro-based investors to invest in assets in Norway.

Figure 10: Policy rates and estimated neutral rates



Source: Macrobond, Bloomberg, Norges Bank and ECB

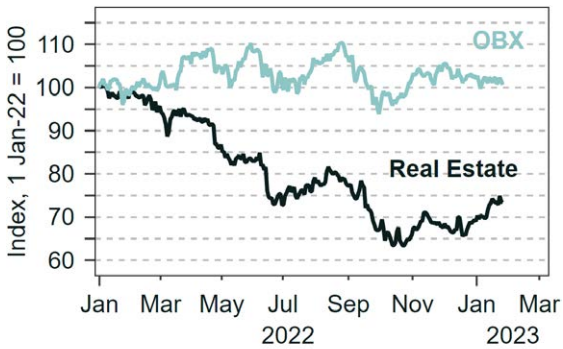
The interest rate differential could also remain favourable. The neutral rate of interest in Norway and in the eurozone is likely to be fairly similar and in the region of 1.5–2.0 per cent (according to Norges Bank and the ECB). If interest rates were to gradually fall to their natural levels in the next few years, it would mean a negligible differential between Norway and the eurozone.

Light at the end of the tunnel

Interest rates are likely to be nearing their peak in Norway, the eurozone and the US. How quickly they eventually fall will depend on trends in the real economy and on inflation. A potential recession will also affect corporate earnings.

Uncertainty around both interest rates and corporate earnings has continued to trouble the asset markets since last summer. The stock market has slumped, and property shares have suffered badly, in part because property is relatively capital-intensive and therefore interest rate sensitive.

Figure 11: Oslo Stock Exchange, OBX vs real estate



Source: Macrobond

The Norwegian and Nordic market for commercial property has not seen a corresponding fall in transaction values despite the hefty rise in financing costs. The transaction market has slowed down considerably since 2021, however, and it would appear that many investors are sitting on the fence as they wait for the outlook to become clearer.

During the first six months we expect increasing clarity around the future of both interest rates and corporate earnings. Interest rates will probably remain relatively high compared with 2020 and 2021, although they will come down from today's levels. We still expect credit spreads in the financial markets to narrow as uncertainty starts to dissipate, thus boosting liquidity in the commercial property market. The coming months are likely to be tough, but as summer approaches we expect to begin to see the light at the end of the tunnel.

Liquidity returns

by Sindre Vesje Bråtebæk and Erik Mikael Johnsen - Akershus Eiendom

Last year ended with significant uncertainty and low liquidity in the Norwegian transaction market. However, we expect liquidity to gradually improve as we move towards summer. Our yield estimates remain unchanged for now, but we predict a slight further rise in the not too distant future. Favourable changes in the interest rate differential between the Euro and Krone, and more comparable yield gaps can help generate more interest from euro-based investors this year, something which might counter potentially lower activity from Swedish investors.

Highlights in the transaction market

The transaction market is still characterised by macroeconomic uncertainty and reluctant investors. The market is considerably slower with 2022 volumes totalling almost NOK 90 billion, down 44 per cent from the 2021 peak. The number of transactions has remained relatively high, but there are now longer gaps between the reference transactions as a result of lower liquidity in the market along with heightened demand for returns. Market views amongst investors differ greatly and are changing rapidly in line with the volatile interest rate market. There is often a considerable distance between the seller's price expectations and the buyer's willingness to pay. Ongoing and recently completed processes demonstrate a desire to buy amongst investors, but access to credit from both banks and bonds is challenging.

Wall of refinancing

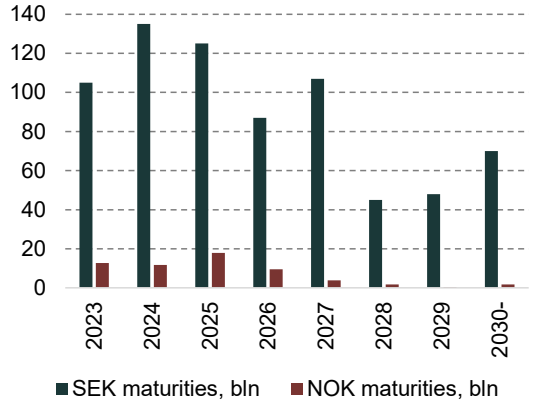
The financing market has changed fundamentally over the past twelve months. Data from Union's bank survey shows that a property investor's overall borrowing rate for new 5-year loans has risen by 230 basis points in a year – from 3.76 per cent in Q4 2021 to 6.06 per cent in Q4 2022. The 5-year swap rate has fallen by around 40 basis points since the survey was carried out, thus highlighting the volatility in the interest rate market.

The majority of property investors rely on borrowed capital to fund property acquisitions and projects and are therefore sensitive to changes in the lending terms, which are impacted by interest rates, credit margins and loan to value ratios. As described in the macro section of this analysis, lending volumes have been throttled as a result of uncertainty in the property market.

This is reflected in reduced liquidity and lower transaction volumes.

Access to financing will be crucial for liquidity in the market in the immediate future. Large volumes of Nordic bonds are due to reach maturity in the coming years. Bonds worth around NOK 750 billion have been issued to Nordic property companies, of which around NOK 250 billion will reach maturity over the next 18 months. In Norway bond debt makes up only 15 per cent of all capital borrowed by property companies. The rest are bank loans. In Sweden, meanwhile, there are far more listed property companies, and no less than 40 per cent of borrowed capital comes from the bond market. Adding the size of the Swedish property market to the equation, a clear picture emerges of refinancing risks in the Nordic property sector

Figure 1: Norwegian and Swedish bonds are coming due



Source: Nordic Trustee / Stamdata

Figures from Nordic Trustee/Stamdata show that NOK 25 billion worth of bond loans issued to property companies in Norway will reach maturity by the end of 2024. The majority of these bonds have a term of 3–5 years and will therefore have been issued at a time of significantly lower interest rates and credit spreads than investors can currently achieve in the market. The refinancing risk therefore appears to be lower in Norway than Sweden.

When reaching maturity the loans either have to be refinanced or redeemed. Yet with rising interest rates and credit spreads, the risk-adjusted return on other financial products has become increasingly attractive. As an example, rapidly rising interest rates are once again making government bonds a better option for some investors. This could make refinancing in the bond market more difficult. Figures from the Swedish bond market do indeed show that the volume of bonds issued fell by 50 per cent between 2021 and 2022. Businesses may have to look for alternative refinancing, usually bank loans, in order to refinance their bonds as they mature.

Although the sheer volume of maturing bonds is high, there are multiple factors to suggest that the banks will be able to put up fresh capital for good projects. On the whole, the banks are considerably more robust and better capitalised than during previous crises. Rising interest rates are in themselves also broadly beneficial to the banks as they are increasingly able to earn money from deposits. The banking sector is therefore expected to see rising profits in the times ahead.

When will sentiment turn?

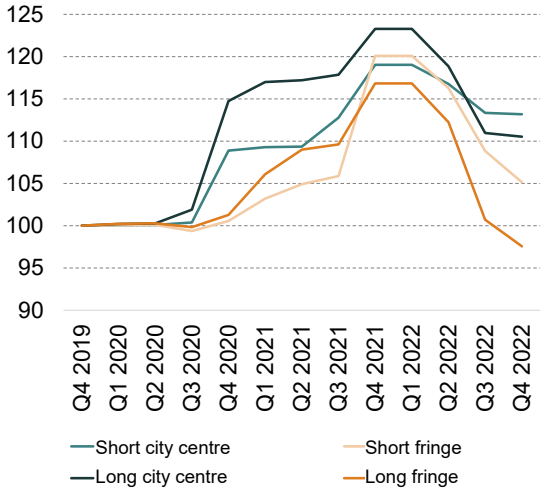
The key question in the transaction market is when sentiment will turn and liquidity in the market return.

As described in the macro analysis, long-term interest rates have fallen in the New Year from the extreme highs seen in Q4 last year. Norwegian long-term interest rates follow international trends and could continue to fall if the US enters a recession. Interest rates in Norway, the US and the eurozone are expected to peak in the first six months of the year, which could help reduce uncertainty and thus stimulate liquidity in the market leading up to the summer. With a more predictable economy, the market is likely to rebound, although the risk in terms of property values remains on the downside.

Yield estimates unchanged

We are maintaining our yield estimates from October for the time being but expect yields to increase slightly in the coming months. Even though the 5-year swap rate has fallen by more than 70 basis points since its October peak, current interest rate levels do indicate further upward pressure on property yields. The rise in office rents in Oslo has begun to flatline and will probably not serve to neutralise further yield increases. Given our predictions, we have recorded a drop in value of just over 5 per cent for a typical city centre property on a short lease compared with the peak. For a typical property on the Oslo fringe with a long lease, the fall is up to 15 per cent, in our view. If yields were to rise slightly as we predict, it will probably also make property values fall a bit further. Yet the effect will vary depending on location and property type.

Figure 2: Akershus Eiendom valuation index as of Jan 2023

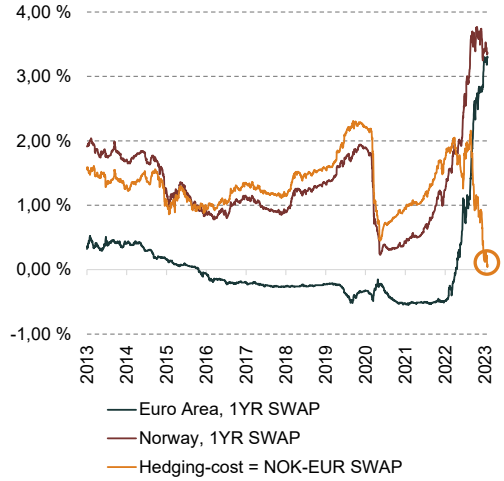


Source: Akershus Eiendom

More euro-based investors?

Norwegian interest rates have been higher than eurozone interest rates for more than 20 years. At the same time the differentials between property yields in Norway and other European countries have been far lower. This has probably made it less attractive for many European property investors to invest in Norway.

Figure 3: Interest rate differential Norway vs Euro area

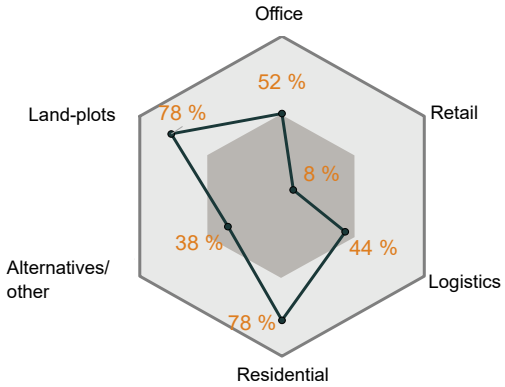


Source: Macrobond

International investors have normally made up 15–20 per cent of the Norwegian transaction market in the past 15 years. Of those, around half were Swedish. For geographical, financial and cultural reasons, Swedes tend to apply a different investment rationale than other international investors in Norway.

Swedes are the only international group investing broadly across property types in Norway – including land-plots. Other international capital has been aimed at relatively stable office and retail properties, with recent tendencies also toward opportunistic strategies as interest rates increase.

Figure 4: Swedish share of all international property acquisitions in Norway last 10 years based on value



Source: Akershus Eiendom

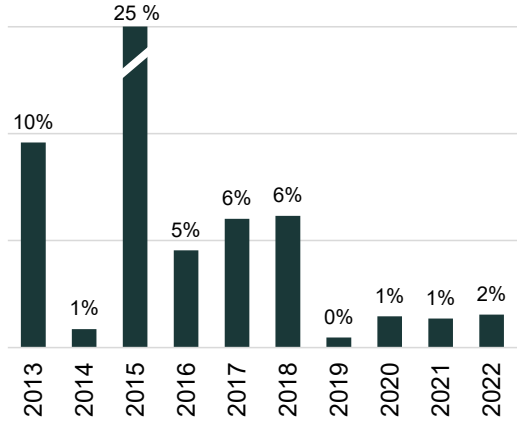
As a result of a struggling Swedish property sector, we consider it possible that the proportion of Swedish investors in the Norwegian market could fall in the next few years. We may see increasing interest from euro-based investors, on the other hand. Before 2018 european investors outside the Nordics were responsible for around 6 per cent of all commercial property purchases in Norway – despite the mentioned unfavourable interest rate differential.

Over the past five years, however, European investors outside the Nordics have provided limited activity in the Norwegian property market. The graph above shows how this could be related to Norges Bank starting to raise interest rates in 2018, while policy rates in the eurozone remained in the negative range. This is now beginning to change.

As described in the macro analysis earlier in this report, we expect the policy rate in the eurozone to overtake the Norwegian policy rate in the first six months of the year, something which has never happened before. This would cut hedging costs and otherwise create a more balanced yield gap – the gap between yield and prevailing interest rate – between Norway and other European markets. This could in turn make Norway a more attractive investment case, relatively speaking.

The example below highlights how much of an impact the interest rate differential and higher hedging costs will have on IRR for different international investors. The imagined investment is a moderately geared core+ investment opportunity in Norway in January 2022 and January 2023. Both are financed with a 5-year swap. In January 2022 the interest rate differential was high, and the IRR for a euro-based investor would have been 2.1 percentage points lower than for a Norwegian investor, all other things being equal. By January 2023 this difference had almost been eliminated. We are also seeing dollar-based investors gaining an advantage compared with Norwegian investors.

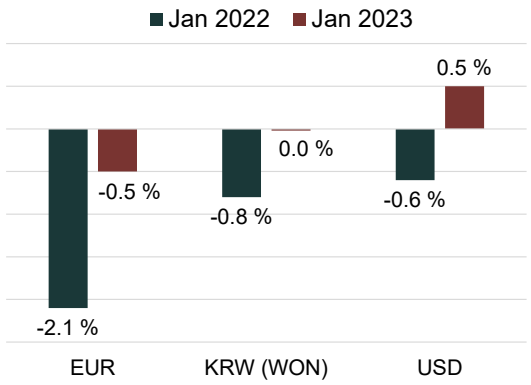
Figure 5: Share of international capital in the Norwegian transaction market (excl. Nordic investors)



Source: Akershus Eiendom

European investors have not entirely disappeared in the past five years, they have simply come up short in the final bidding whenever they have been involved. This could change with the more advantageous interest rate differentials.

Figure 6: Effect of hedhing costs on IRR for international investors investing in NOK (based on 5yr swap)



Source: JLL, Akershus Eiendom

Conclusion

We expect liquidity in the transaction market to increase gradually as summer approaches. As uncertainty around interest rates and corporate earnings dissipates, we expect credit spreads to narrow and access to financing to improve. There is a large amount of capital in search of good property investments, and the most

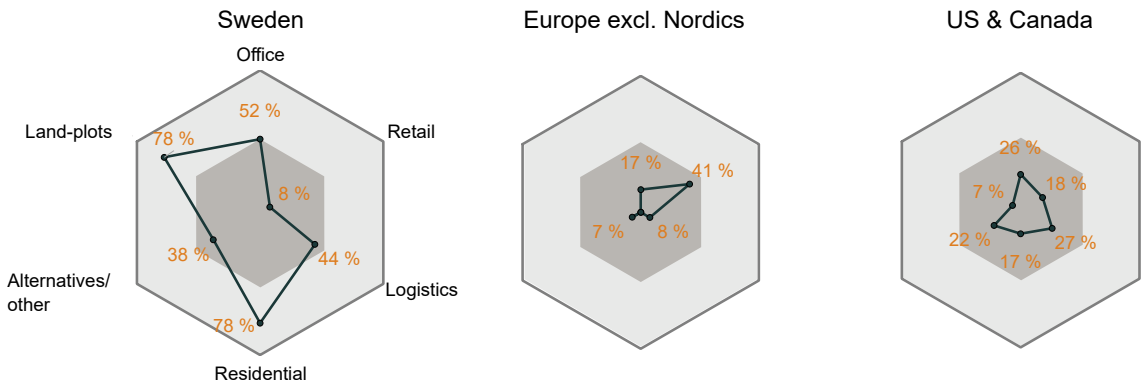
attractive investment cases are likely to continue to generate healthy interest even if the general market for commercial property remains slow in the short term. We are keeping our yield estimates for commercial property unchanged for the time being, but do expect them to rise slightly in the times ahead. This could put further downward pressure on property values, but the consequences are likely to differ considerably, depending on location and property type.

Troubles in the Swedish market could reduce the proportion of Swedish investors in the Norwegian market this year. However, we do believe that the proportion of euro-based investors could increase as a result of a more favourable interest rate differential, lower hedging costs and more comparable yield gaps.

Appendix:

Proportion of international acquisitions in Norway in the past 10 years, by category

- Swedes account for 52 per cent of office properties acquired by international capital in the past 10 years.
- Swedes are active investors in almost all property categories in Norway, including land.
- Danes account for 15 per cent of foreign logistics acquisitions in Norway.
- North-American investors are surprisingly active in a broad selection of Norwegian commercial property.



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