MARKET IN MINUTES
Savills Research

Real estate market under interest rate shock

Words: Matthias Pink

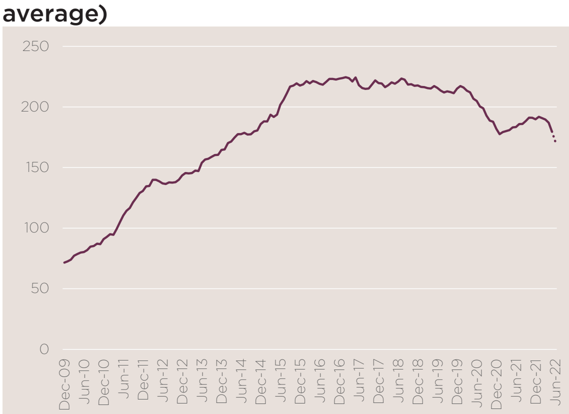
Activity on the investment market has cooled rapidly in recent weeks and the recovery from the consequences of the pandemic that had been gathering momentum since the beginning of last year was abruptly interrupted. Already in April there were very few transactions and in May we registered fewer than a hundred sales for the first time in over ten years. The 12-month average is thus approaching the COVID-19 low again and our observations from ongoing sales processes suggest that it will be even lower in the summer (see Fig. 1).

The current development is reminiscent in its dynamics of the beginning of the COVID-19 pandemic, but the driving forces are completely different. This time, too, there was an external shock event with the Russian invasion of Ukraine. However, its direct consequences for the German real estate market are negligible. The war and its consequences have, however, further driven up inflation, which was already high, and thus also ensured that the turnaround in interest rates will take place earlier and be stronger than previously expected. Both short- and long-term interest rate expectations have risen sharply within a very short period of time (see Fig. 2).

Although other factors also play a role, the current stasis on the investment market seems to be primarily due to this "interest rate shock". It is having an effect primarily through the financing channel. The cost of debt capital has more than doubled, reaching a level that roughly corresponds to, and in some cases even exceeds, prime yields in many segments. In such cases, the previously clearly positive leverage effect is partly reversed and the use of debt capital reduces the (cash flow) return of the buyers. Either way, the increased financing costs lead to many investors recalculating in ongoing bidding processes and reducing their willingness to pay. This drags out many processes and sometimes properties are taken off the market again by the seller because the sales price expectation cannot be realised. The current low number of completed transactions is an expression of this. In addition, some investors are refraining from purchases altogether until further notice. The thinned-out buyer base in turn is causing many owners to postpone planned sales. Since the sales processes started today are the transactions of tomorrow, we expect a comparatively low number of completed transactions in the coming months as well. However, this also means that planned purchases and sales are piling up and will be made up for, at least in part, at a later date.

As usual in phases of low market liquidity, it is difficult to determine prices. In practically all of the current sales processes we have observed, the bids are below the price level of the first quarter. There have already been individual sales at presumably lower prices, although their number is too small to be able to derive a market price level from them. Nevertheless, we expect initial yields to rise in all segments and risk classes due to the increased financing costs alone. Pure equity investors could theoretically stabilise prices in the core segment, but there are probably too few of them. In addition, the low-yielding properties in particular are also sensitive to interest rates on the income side. This is especially true if the mostly long-term fixed rental income is not (fully) hedged against inflation. Against this background, we consider the residential sector, for example, to be particularly vulnerable in the current environment. Outside the core segment, the higher financing costs are compounded by higher construction and fit-out costs as price-reducing components. It remains to be seen how high the rise in yields will be.

Fig. 1: Number of transactions (rolling 12-month average)



Source Savills

Focus on selected figures

+ 170 bp.
Since the end of last year, 10-year swap rates have risen by about 170 basis points. The cost of financing real estate has roughly doubled over the same period.

<100
In May, we registered less than a hundred transactions. The last time there were so few was about eleven years ago.

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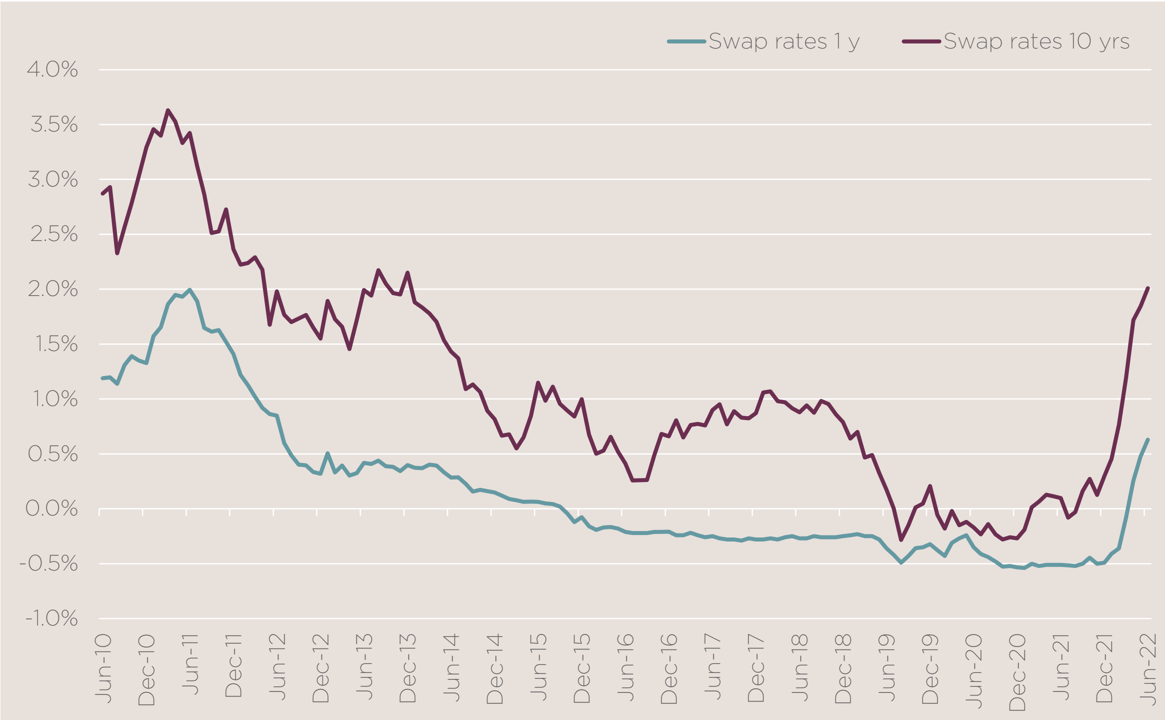
Figure 2: Swap rates



Source Savills based on investing.com

We interpret the current development as a turning point in the investment cycle. Falling interest rates have been one of the driving forces behind the extremely high momentum on the real estate investment market for years, and recently probably even the decisive one. This driving force has now lost its tension not only temporarily, but for the foreseeable future. The fact that the interest rate turnaround came earlier and was more severe than expected is currently causing a kind of shock paralysis on the market. However, we believe that the market will soon return to normal activity and that the cycle turnaround will be gentle overall. Although capital market interest rates have risen extremely quickly, the curves should flatten out considerably from now on, especially at the long end. Firstly, this argues for stable real estate yields once they have adjusted to the new interest rate environment. Secondly, the yield level on the bond markets will probably remain so low for the time being, especially for cash-on-cash-oriented investors, that real estate (together with equities) will probably remain the preferred asset class for most investors after a corresponding price correction. This is even more true when adjusted for inflation. Because the temporarily weak euro opens a window for foreign investors to make favourable purchases, the demand side could be additionally supported. In our opinion, the real economy poses greater risks than the capital market. If the interest rate shock were followed by an economic shock, the real estate market would also face a strong correction. However, this does not seem to be the case at the moment. Economic expectations have stabilised recently and with them the prospects on the rental markets. Another supportive factor is that higher interest rates together with high inflation should largely prevent the overshooting of supply that is typical for the end of a cycle.

Savills Team

Please contact us for further information

Marcus Lemli
CEO Germany / Head of Investment Europe
+49 (0) 69 273 000 12
mlemli@savills.de

Matthias Pink
Director / Head of Research
Research Germany
+49 30 726 165 134
mpink@savills.de

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