European residential real estate firms face up to 10% decline on average in fair values by end-2024

Fair values of residential real estate portfolios of Europe's top property investment firms will fall by as much as 10% on average by the end of next year as yields rise. Rental income growth is unlikely to offset higher cost of debt in the medium term.

By Philipp Wass, Executive Director, Corporate Ratings

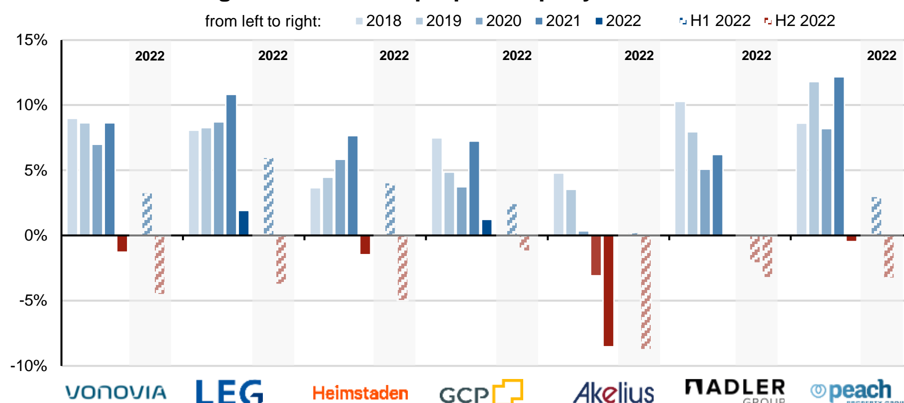
Our forecast for falling fair values until at least end-2024 follows the average 4% decline in the second half of 2022 across some of the biggest European residential investment companies by assets – such as Akelius Residential Property AB, Grand City Properties SA, Heimstaden Bostad AB, LEG Immobilien S.E., Peach Property Group AG and Vonovia SE (A-/Stable) – as house prices fell in many European countries.

However, the implications for credit quality remain modest. For many companies, even a 10% decline in fair values – recognising that declines will vary within and between locations and residential property categories -- leaves plenty of equity protection because current loan-to-value ratios are typically between 40%-50%. In addition, real estate companies with significant residential exposure face real but manageable pressure on leverage ratios.

The tight supply and demand balance for homes in most markets favours steady rental cashflow growth even though that might will not likely be enough to prevent a decline in interest cover. All in all, this makes significant credit-rating downgrades unlikely for investment-grade issuers.

Still, most central bank base lending rates in Europe and North America are either equal to or in line with prevailing yields of the real estate companies – averaging 3-4% at YE 2022 – and we do not see a near-term halt in monetary tightening. Like-for-like rental growth in the next couple of years will not make up for this, even if supported by tight markets most landlords operate in. So, the fair value of investment properties will be under constant pressure.

Figure 1: Fair value change of investment properties per year for selected residential companies



Source: company reports, Scope Ratings

Real estate companies take action to protect leverage ratios

To tackle pressure on fair values and keep leverage under control, residential landlords will focus on reducing indebtedness in various ways.

First, they will maximise free operating cash flow, focusing their investments on weatherproofing portfolios while cutting back on new development projects -- an approach taken by Germany's Vonovia and LEG Immobilien -- as inflation and supply-chain constraints have eroded the economics of building new homes. Developers would have to charge unaffordable rents.

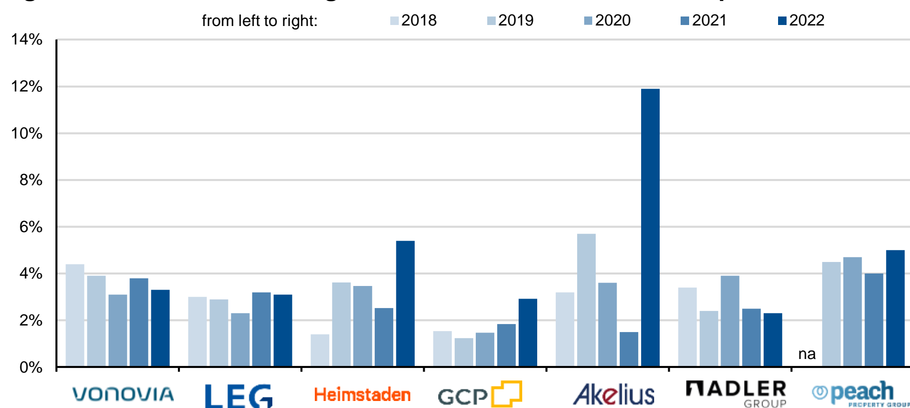
Furthermore, companies are becoming more selective regards capital expenditure due to the higher cost of capital, focusing on investment needed for ESG compliance.

Secondly, they will free up capital by selling parts of the portfolio, either via joint-venture structures[1], condominium sales or en bloc. SBB i Norden (BBB/Stable) sold a 49% stake in its social infrastructure portfolio for public education to Brookfield end-November 2022; Vonovia sold 14,750 flats in 2022 to Berlin public housing companies and plans to dispose of around EUR 2bn of assets in 2023. LEG plans to dispose 5,000 flats. As such we expect Europe's leading property investment companies to be net sellers in the coming 12-18 months.

The ability to sell apartments at current market rates is, however, questionable as investment markets are expected to remain in limbo for the next couple of months, with reduced investment activity until sponsors accept lower rates of return and long-term interest rates stabilise.

We forecast like-for-like rental growth to remain resilient in 2023 to 2025 averaging between 2-5% per year in most of Europe, though in some housing segments, landlords will struggle to achieve those rates. Rents for non-energy efficient flats in markets with declining demand will be one source of market weakness, given the all-in rental cost will be out of line with tenants' purchasing power. Another danger is unpaid rents as energy and other utility bills drive up the cost of living.

Figure 2: Like-for-like rental growth of selected residential companies



Sources: public information, Scope

Expect subdued activity on debt capital markets by residential property firms

Still, real estate companies' targeted reductions in indebtedness should cap any increase in leverage as measured by a company's loan/value ratio to around 5pp on average and to lead to some improvement in debt/EBITDA up to YE 2024. The likely significant release of capital as soon as markets find a new, sustainable price level will provide additional support.

While companies leverage will increase only slightly, there will be a more pronounced decline in interest cover in the next few years. Main drivers are increasing financing costs that are only partially balanced by anticipated rental growth and interest rate hedges in place.

For now, we expect limited fund raising in debt and equity capital market, with residential landlords focusing on secured lending to keep borrowing costs under control. Relatively long loan maturities (between 4 to 8 years for selected peers), low cost of debt (1.2-2.6%) and high hedging ratios (mostly above 90%) will make the transition digestible from a ratings perspective.

Reassuring as this is, we would caution about the growing stress in residential real estate sector at large. Volatile house prices, rising interest rates, inflation and residual supply-chain bottlenecks make for testing times for housing developers, real estate brokers, construction companies and their suppliers, particularly if they are small and medium-sized enterprises with less ready access to finance.