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Property Market Liquidity

– when will the floodgates open?

Nordanö

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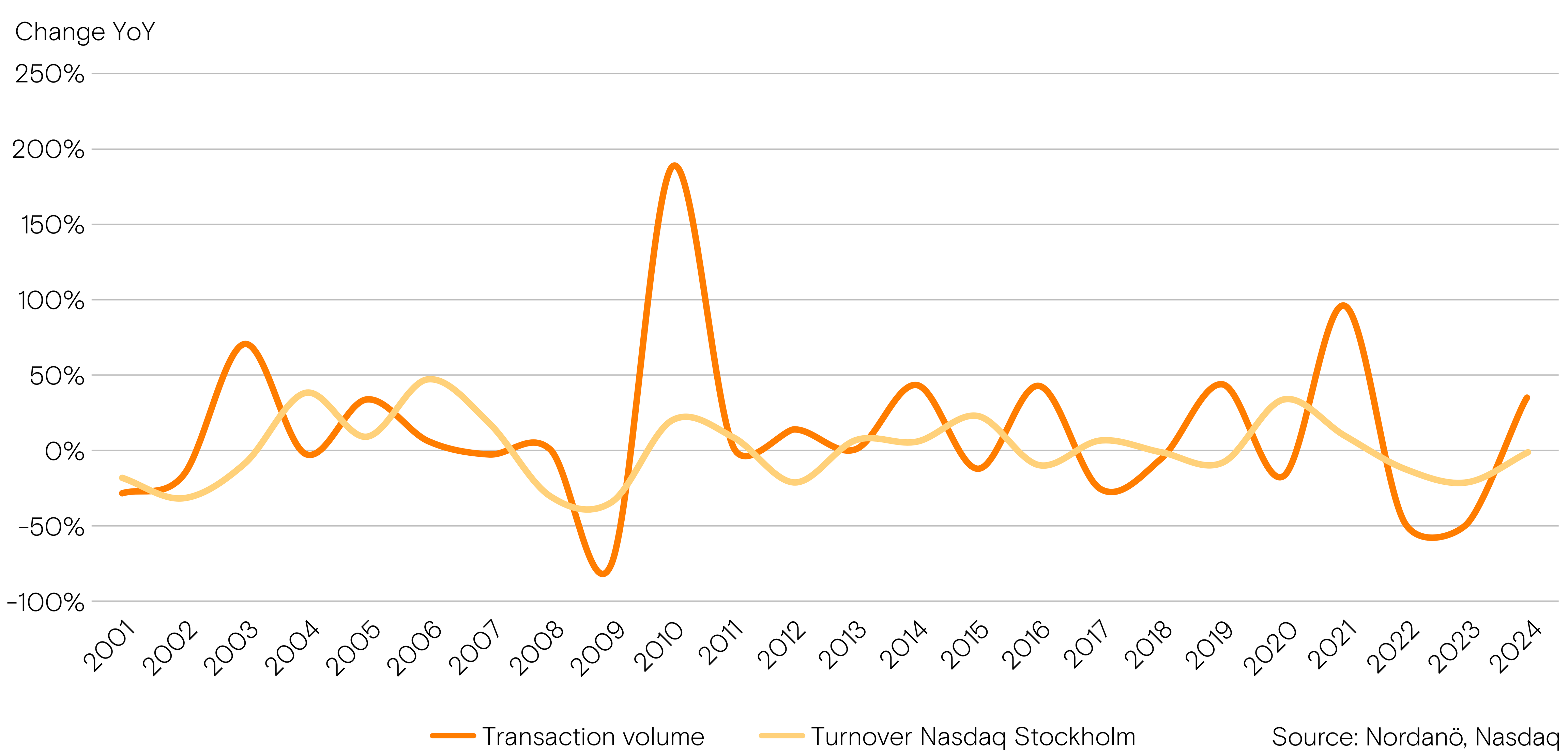
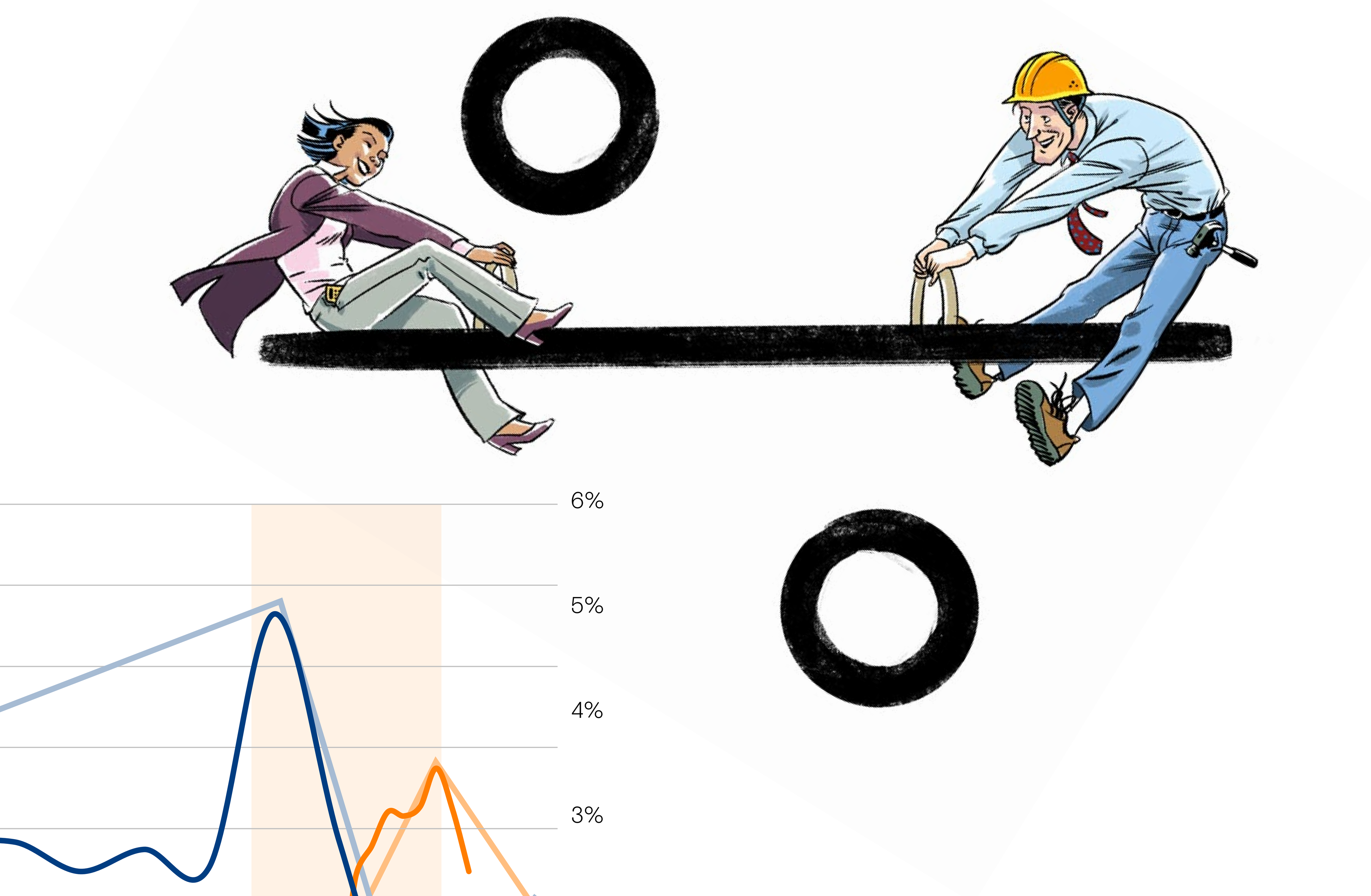
The ebb and flow of liquidity on the property market is an intriguing phenomenon. In challenging times, liquidity on the property market dries up in a dramatic way. These collapses in transaction activity are much more drastic then those of other asset classes, like equities and bonds. The graph below shows changes in transaction volume on the property market vs the stock market. It is obvious, to the naked eye, that the amplitude of the swings on the property market is much larger than on the stock market.

Transaction volatility – properties vs equities



Source: Nordanö, Nasdaq

What factors contribute to periods of frantic activity, followed by "Property crunches" with liquidity drying up? In this article, we analyse the driving factors behind swings in liquidity. What triggers the ups and downs in the transaction market?



What drives liquidity?

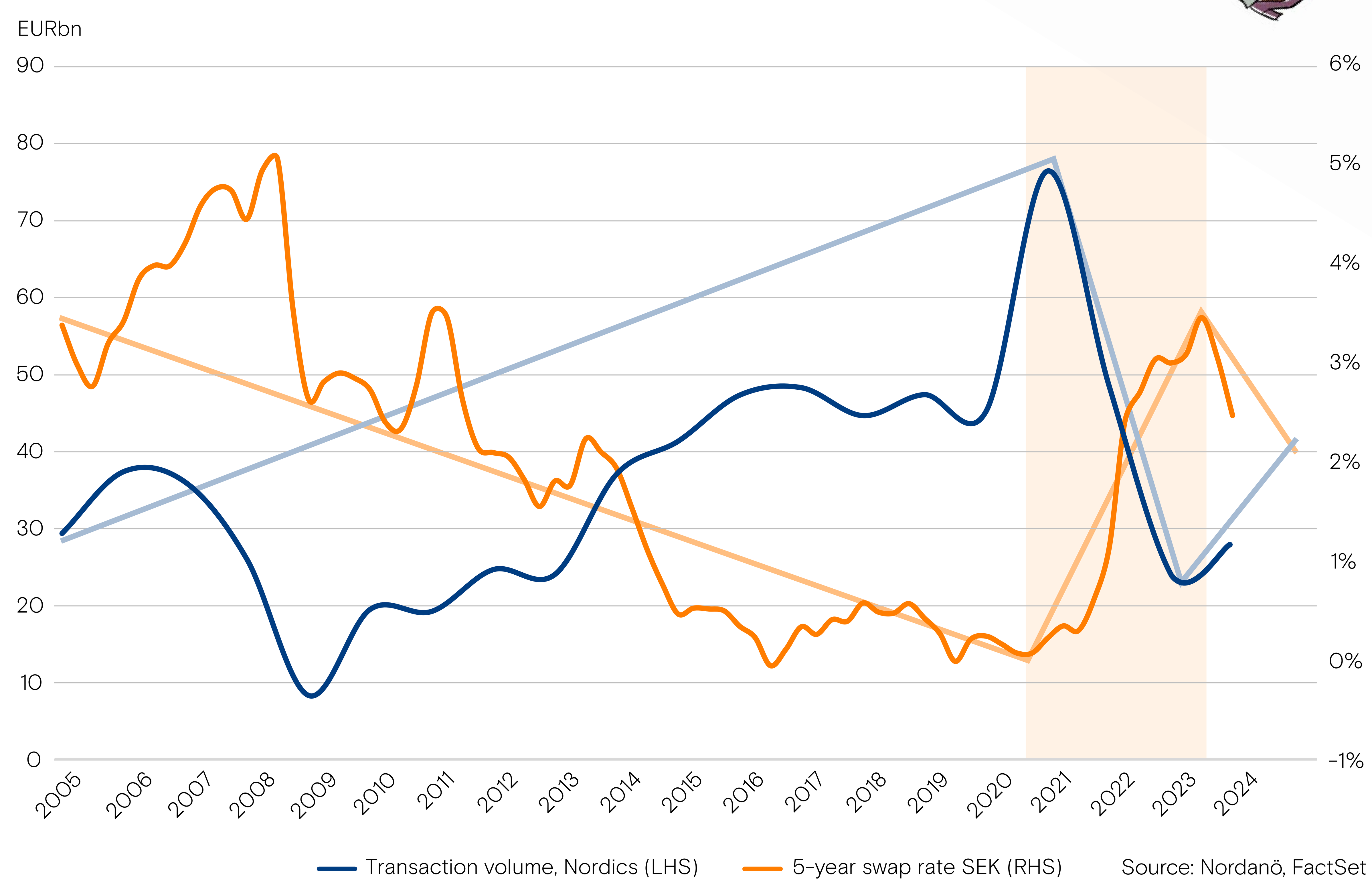
In order to understand the driving factors behind liquidity, we have searched for correlations between transaction volume and a vast number of underlying factors related to:

- the macro environment (inflation, GDP, interest rates, etc.)
- the property market per se (yields, MSCI Capital Growth, etc.)
- the stock market (all-stock indices, property sector indices, VIX, etc.)

After a lengthy and extensive study of possible underlying factors, we found that the short answer to what drives property market liquidity boils down to one factor … drumroll … interest rates.

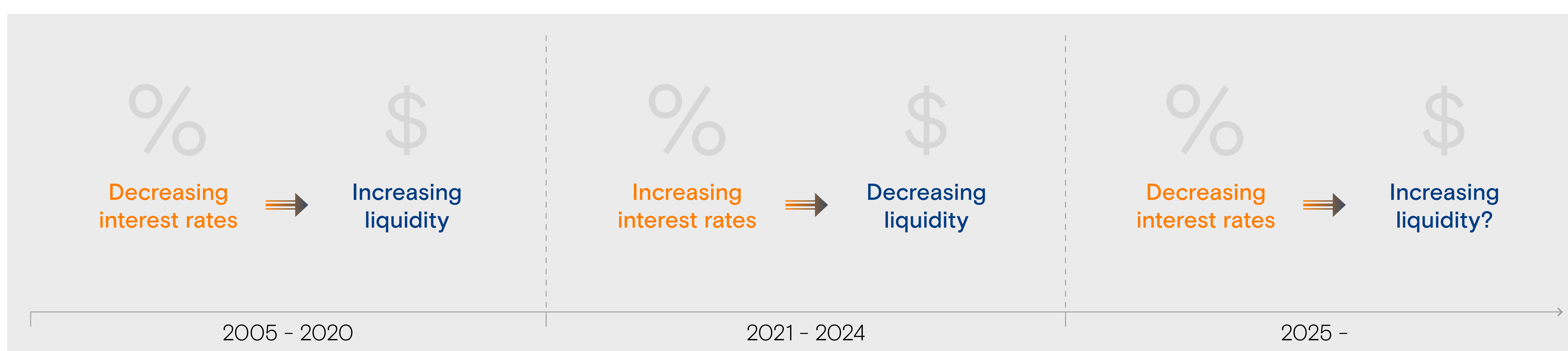
Looking at the graph to the right, we can see three distinct periods of time. Between 2005 and 2020, interest rates decreased, while transaction volume increased. In 2021-2022 there was a sudden increase in interest rates which led to a sharp contraction of transaction volume in 2022-2023, i.e. with a lag of one to two years. More recently, in 2024, interest rates have fallen sharply, and thus we should expect an increase in market activity and transaction volume in 2025.

Nordic total transaction volume vs 5-year swap rate



Transaction volume lags interest rates

The highest correlation between transaction volume and interest rates, is with a one-year lag, i.e. transaction volume lags interest rate changes by one year (but the two-year lag correlation is also significant). There are several reasons for the lag: firstly, property transactions take time to execute and secondly, the cash flow effects of new interest rates take time to materialise, since property investors use swap contracts to hedge interest rate risk.



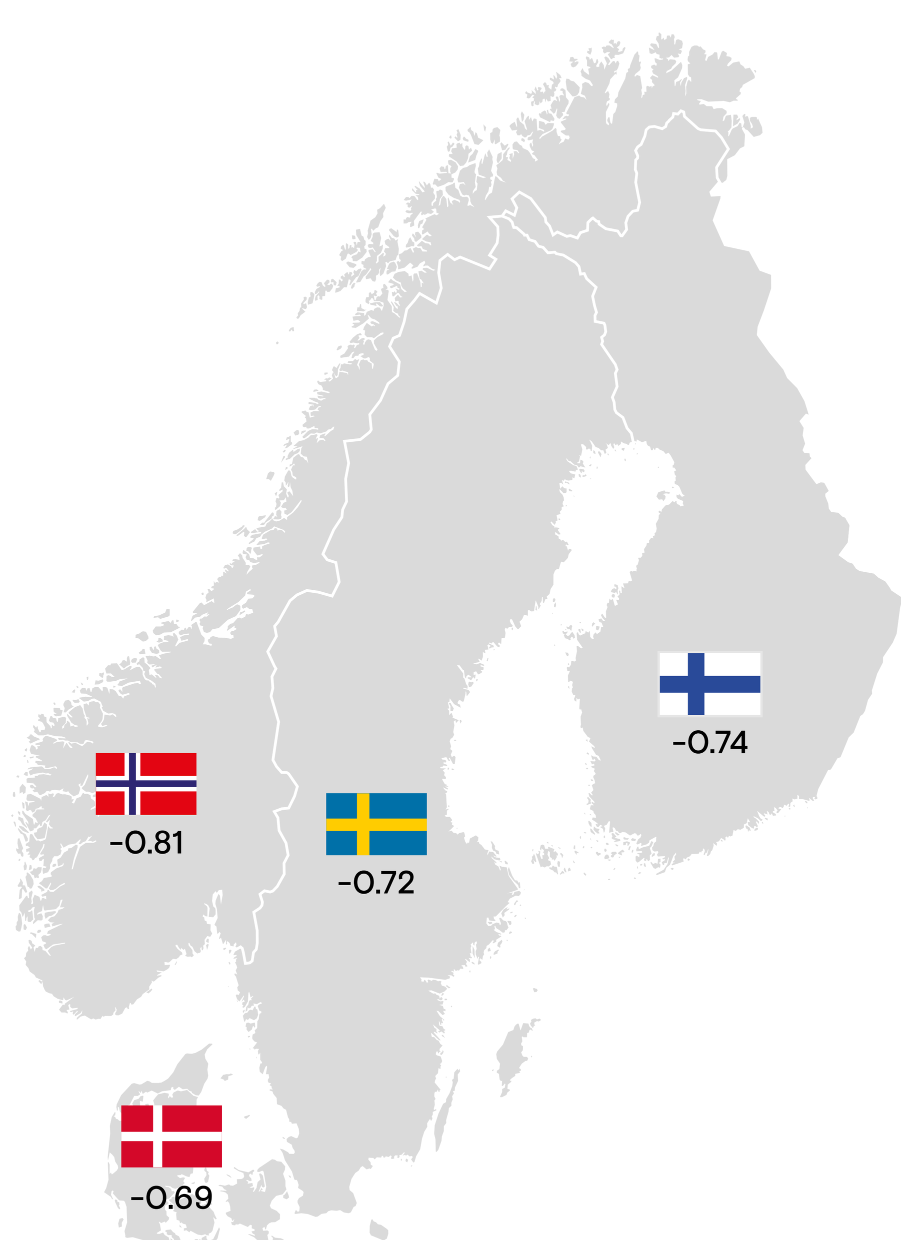
High correlation in all Nordic countries

The correlation between liquidity and interest rates is *very* high in all Nordic countries. This holds true, irrespective of the metric used to measure interest rates; be it STIBOR/Euribor, the 5-years swap rate, government bonds, etc.

The highest correlation is in Norway, probably due to the proliferation of "syndicators" that buy properties and syndicate the equity to smaller investors. The activity in this sector is *substantially* higher during times of low interest rates and vice versa.

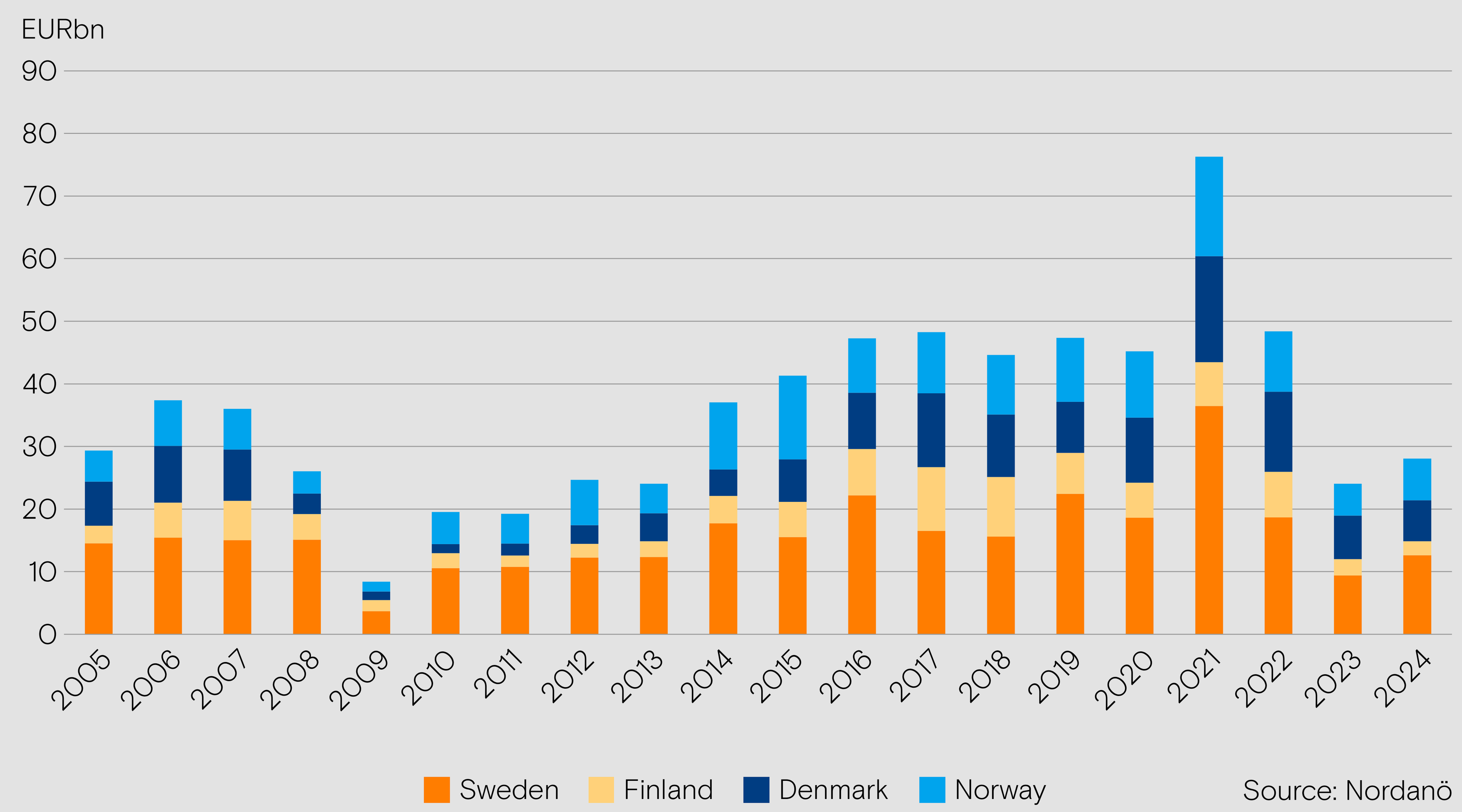
Country	Correlation
Sweden	-0.72
Denmark	-0.69
Finland	-0.74
Norway	-0.81

Correlation between transaction volume and 5-year swap rate 2000-2024 (with one-year lag for transaction volume, see below



Transaction volume in the Nordics

Total Nordic transaction volume per country



Transaction volume in the Nordics has been very volatile, with a low of less than €10 billion in 2009 and an all-time high of over €75 billion in 2021.

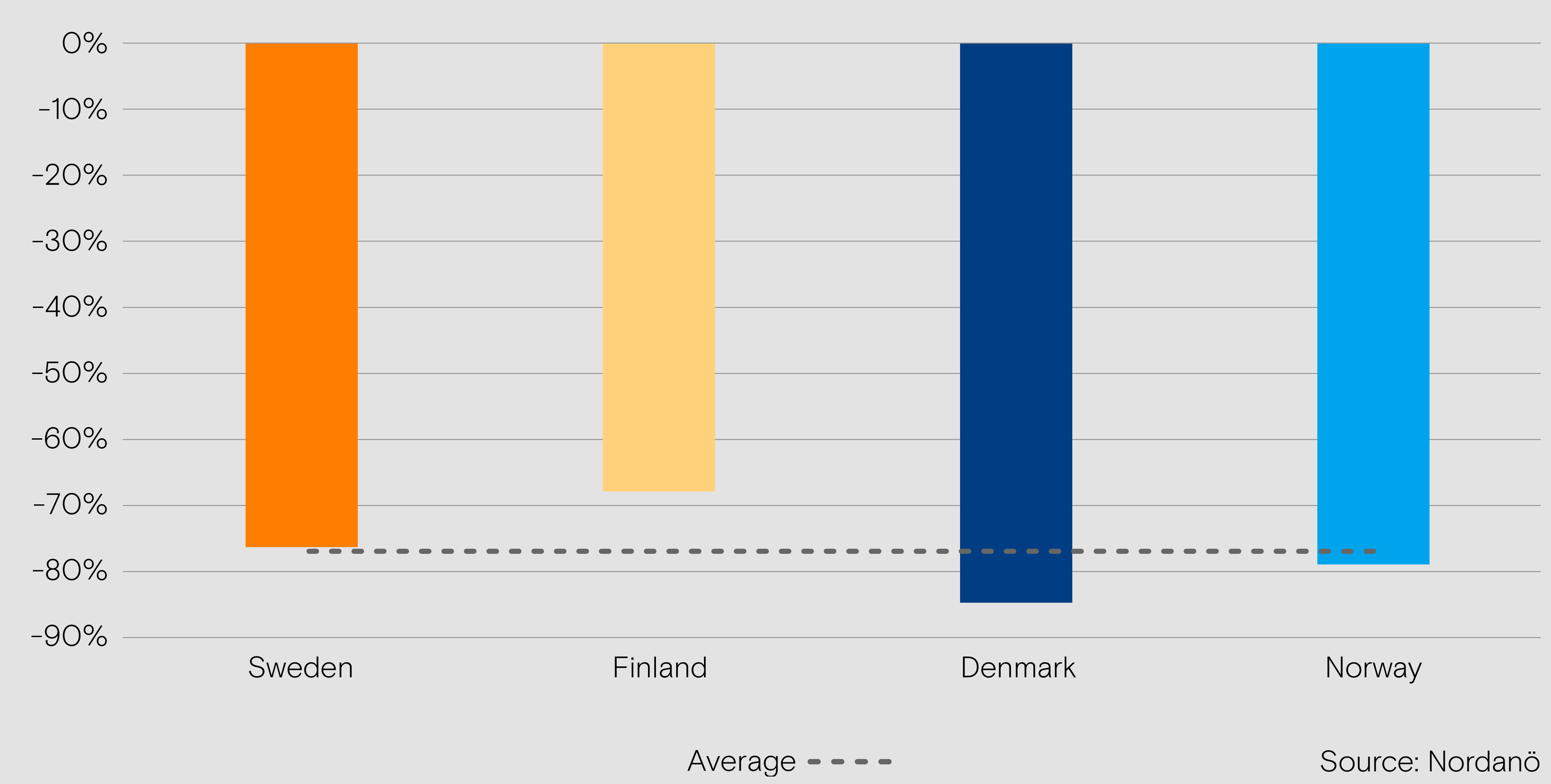
Transaction volume correlations 2005-2023

	Sweden	Finland	Denmark	Norway
Sweden	1.00	0.59	0.78	0.82
Finland		1.00	0.77	0.64
Denmark[1]			1.00	0.73
Norway [1]				1.00

(1) NO/DK from 2005)

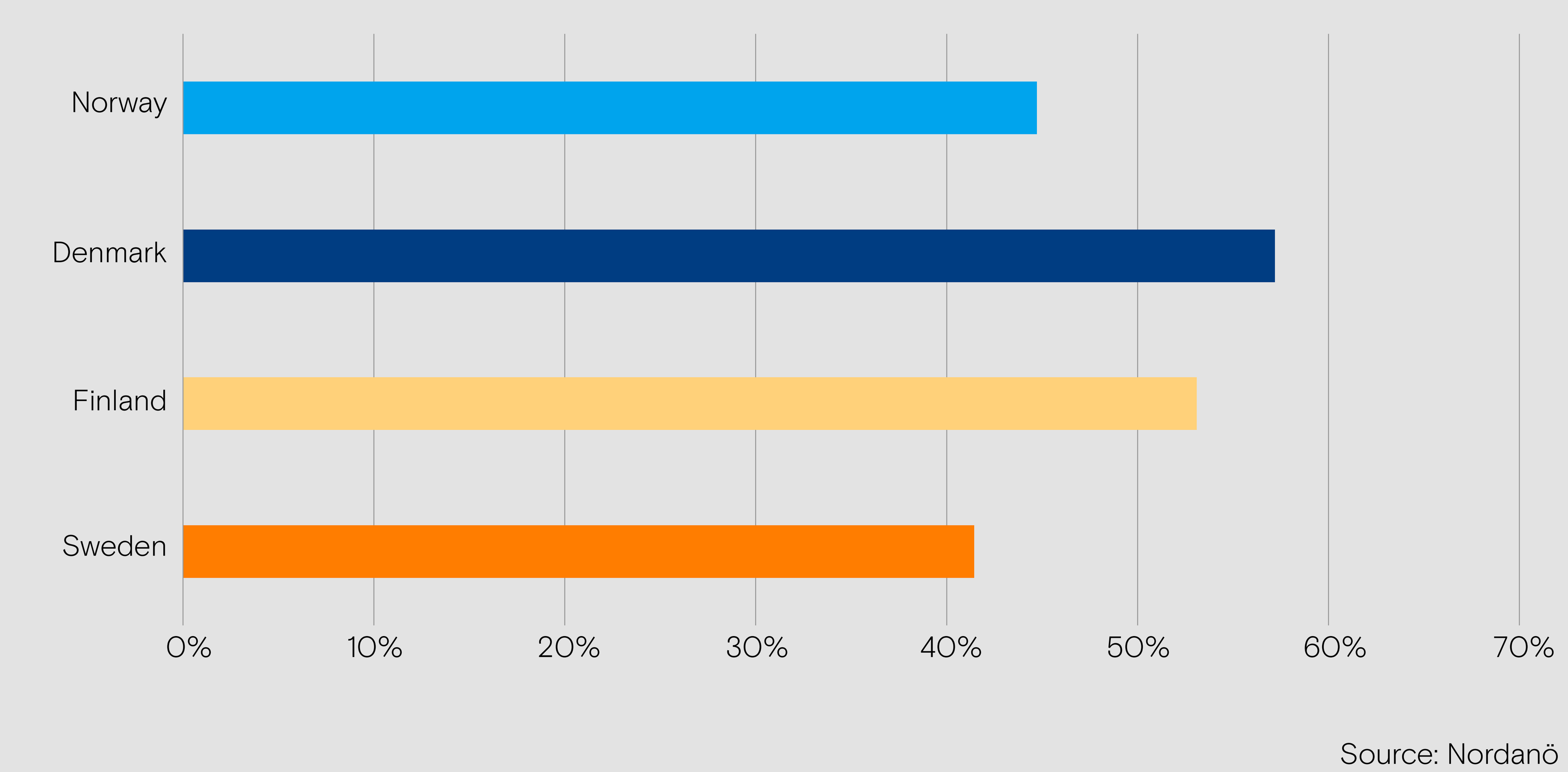
The correlation between transaction volumes in the Nordic countries is very high, although slightly lower for Finland, maybe due to Finland being hit by *specific* external shocks (the demise of Nokia, the collapse of trade with Russia, etc.).

Peak-to-trough 2006 vs 2009



Transaction volume fell by almost 80%(!), on average, in the Nordic countries between 2006 and 2009; a severe shock, to say the least.

Transaction volume volatility 2005-2024



Transaction volume *volatility* is higher in Denmark and Finland, i.e. the transaction volume varies more over time in these countries, possibly due to the inflow and/or outflow of foreign investors in those markets.

The bid-ask spread between buyers and sellers

Why does transaction volume correlate with interest rates? To people in the property sector, this seems like the normal order of things, but if we take a step back, what are the actual reasons for this?

Based on past experience, liquidity in the property market decreases when there is a large bid-ask spread between buyers and sellers. This is rather different compared to other markets, like equities, where spreads between buyers and sellers are thin throughout an economic cycle. In contrast, the property market seems to be a less efficient market, leading to slower price discovery.

To understand the bid-ask spread mechanism, let's look at a scenario with *increasing* interest rates. In this scenario, increasing interest rates trigger a widening of the bid-ask spread; this occurs on *both* sides of the spread.

On the bid side, buyers are willing to pay less for properties, when interest rates increase, for three reasons, depending on the investor type:

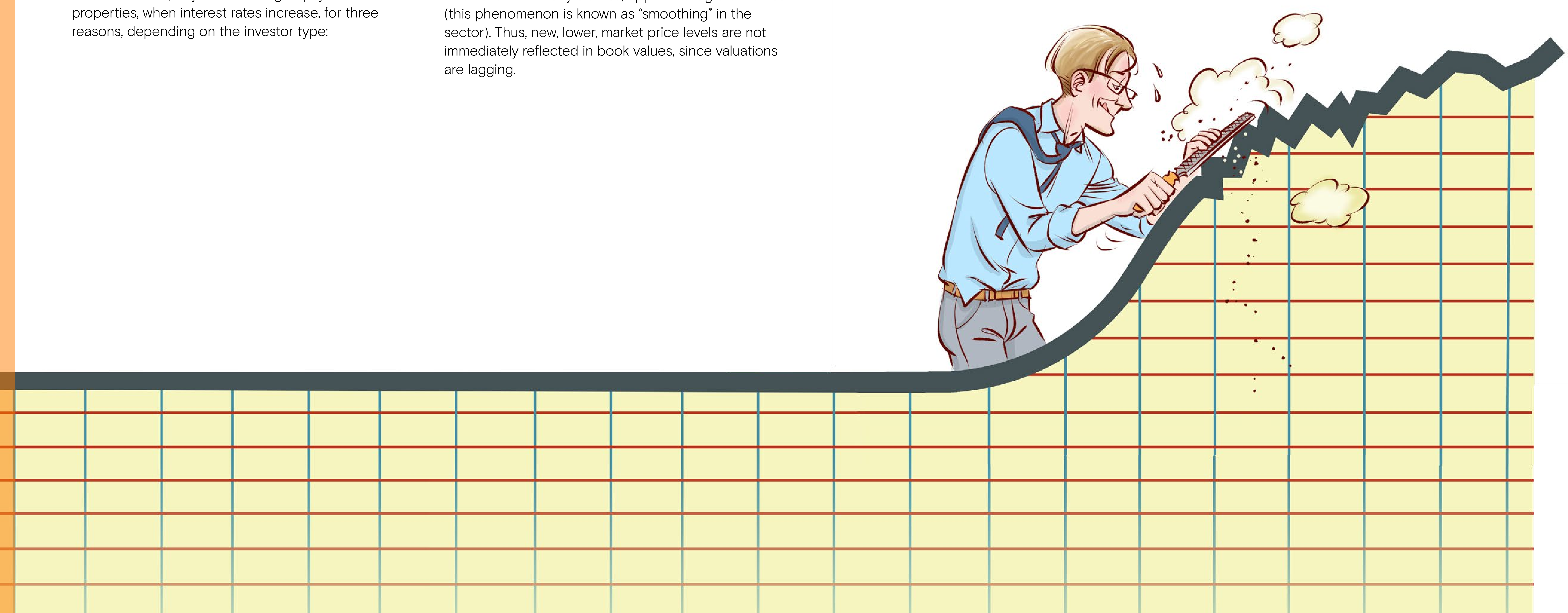
1. For *leveraged investors*, higher interest rates increase their cost of capital, for debt and arguably also for equity.
2. For *institutional investors*, property investments become less attractive, if investors can achieve the same returns by buying low-risk, investment-grade bonds.
3. *Listed property companies* are usually punished by the stock market when interest rates rise, pushing them towards trading at a discount, which makes them less able to acquire new properties.

On the other side of the spread, the ask side, there is also an impact of increasing interest rates. All things equal, increasing interest rates create a downward pressure on market prices for properties but, as has been shown in many studies, appraisals lag the market (this phenomenon is known as "smoothing" in the sector). Thus, new, lower, market price levels are not immediately reflected in book values, since valuations are lagging.

When the "true" market value of properties is below the book value, i.e. below the lagging valuations, many property owners are unwilling or unable to sell at a loss to book value. Sellers tend to wait until book values come down, in order to avoid the loss, even if they truly know that the lagging book values are inaccurate. Thus, lagging book values contribute to the widening of the bid-ask spread.

In the opposite scenario, with *decreasing* interest rates, the reasoning above is also valid, but in reverse. When interest rates decrease, buyers raise the prices they are prepared to bid at, while sellers are more easily able to sell at or above book value.

In any case, the consequences of a change in interest rates, upwards or downwards, take time to materialise in prices, due to the nature of the property market, where every property is unique, which limits the number of comparable transactions.



Why does liquidity matter?

Liquidity on the property market is interesting and important, not only for advisers and brokers that earn a living from transactions, but first and foremost for property investors. There are four main reasons why liquidity is crucial for investors:

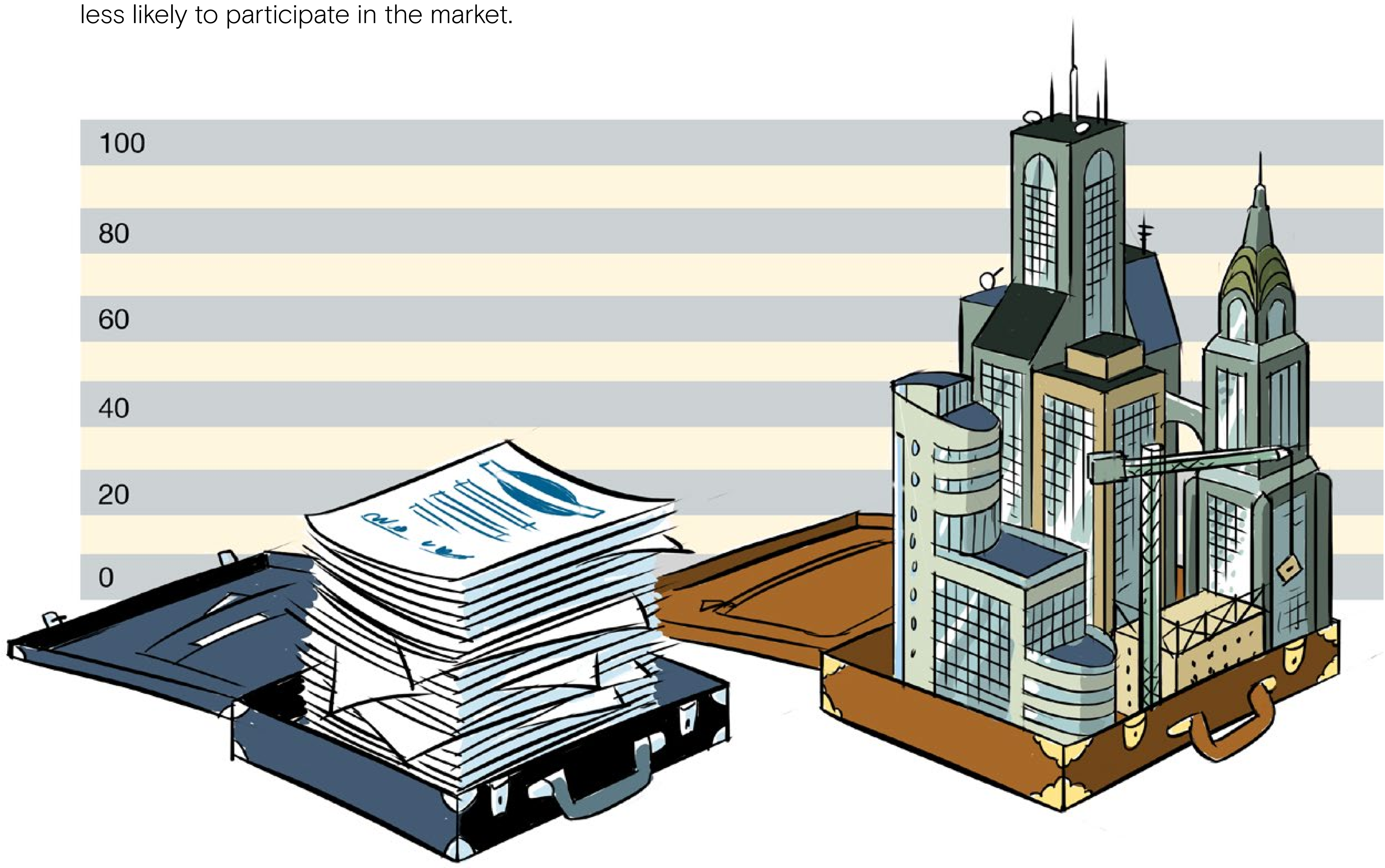
Firstly, investors with a limited investment horizon, like *property funds*, need to be able to divest their assets in a particular window of time. These types of investors typically prefer to invest in markets with high liquidity, like the Nordics.

Secondly, *institutional investors* rely on liquidity in order to increase or decrease their exposure to property in their *asset allocation*.

Thirdly, liquidity is a prerequisite for *price discovery* and a well-functioning market. Without comparable transactions, investors are uncertain of pricing and less likely to participate in the market.

Fourthly, comparable transactions are essential to perform *appraisals* of properties. Listed property companies, under IFRS rules, require market valuations for their balance sheets. In addition, institutional investors need to mark-to-market, as well. Without a liquid property market, that provides comparable transactions on a *granular* level for different geographies and property types, it is impossible to perform meaningful valuations of properties (sometimes valuations may be inaccurate anyway, *despite* abundant market data, but that is a theme for another article).

In summary, liquidity is important for *all market participants;* even for investors who don't trade properties regularly.



Liquidity and the listed property companies

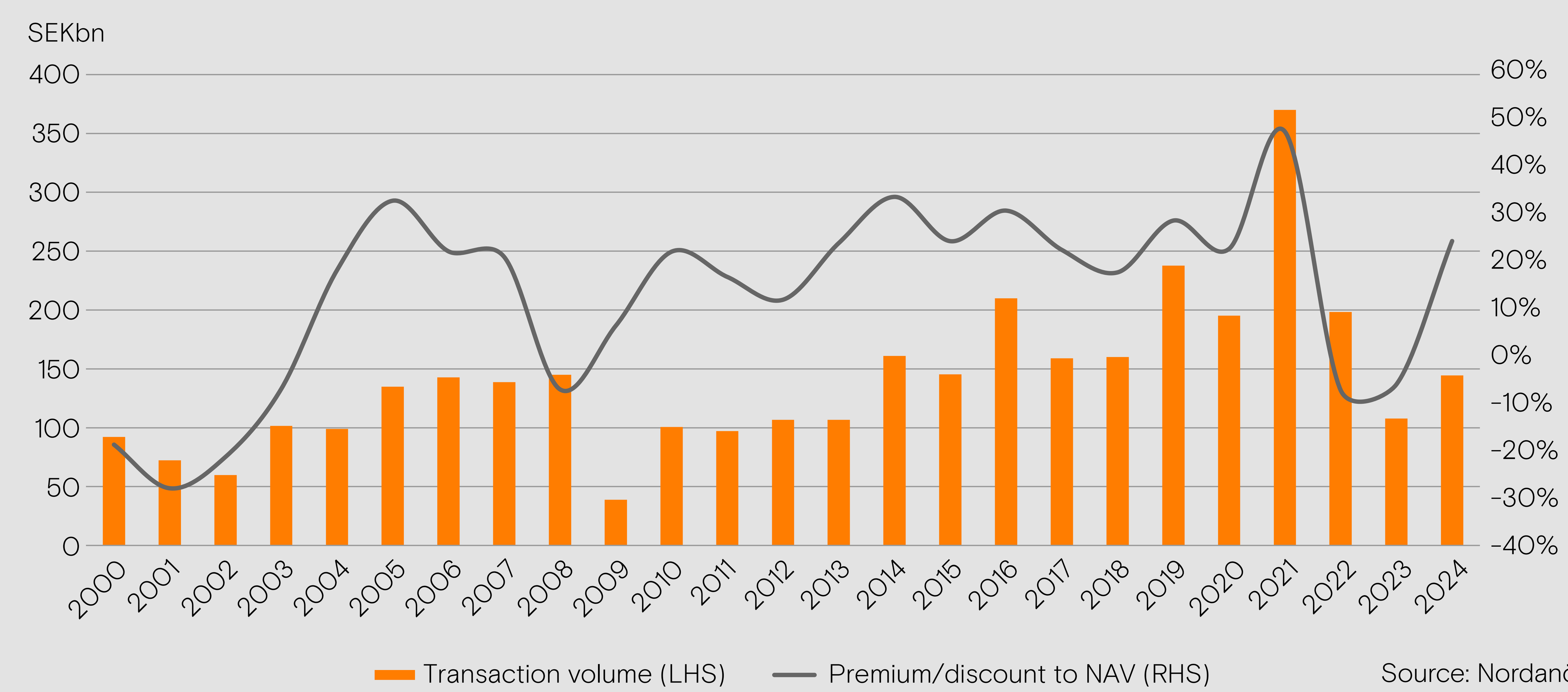
In addition to the high correlation with interest rates, we have also found a correlation (0.64) between liquidity and the valuation of listed property companies on the stock market. In times when listed property companies trade at a premium, transaction volume on the property market is high, while in times when listed property companies trade at a discount, transaction volume is low. There are two main reasons for this:

Firstly, listed property companies contribute directly to liquidity on the property market, since they are active buyers when their shares trade at a premium.

On the other hand, when they trade at a discount, they are somewhat less likely to be active sellers (although they arguably should be).

Secondly, as we showed in our earlier research report "Property shares in turbulent times", there is a correlation between interest rates and premium/discount on listed property companies. Thus, transaction volume, interest rates and the stock market valuation of listed property companies, are all interlinked.

Transaction volume Sweden vs premium/discount on listed property companies



Conclusion

Liquidity is vital for a well-functioning property market; enabling investors to enter and exit the market, to reallocate, to have correct appraisals, etc.

In our analysis we have shown that:

1) Liquidity is highly (negatively) correlated with interest rates.

2) There is a time lag, i.e. interest rates are a leading indicator of liquidity.

3) Liquidity is highly correlated among the Nordic countries.

4) Liquidity is highly correlated with the stock market valuation of property companies, i.e. premium/discount to NAV.

In order to time divestments, investors can benefit from being able to anticipate or, at least, have a view on property market liquidity.

Since interest rates, and expectations of future interest rates, have been on a downward trajectory since late 2023, with the above conclusion of a one- to two-year lag in transaction activity, we should look forward to a welcome increase in activity in the property transaction market in 2025.

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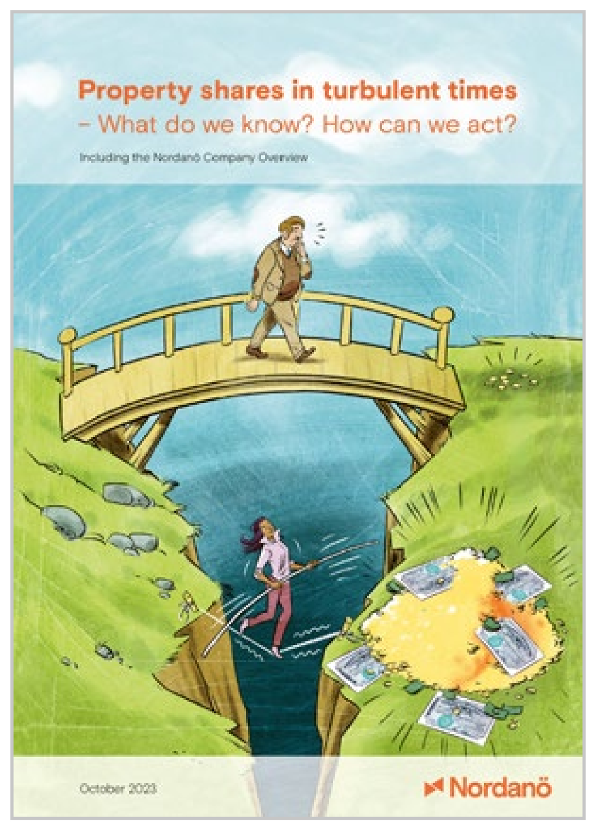

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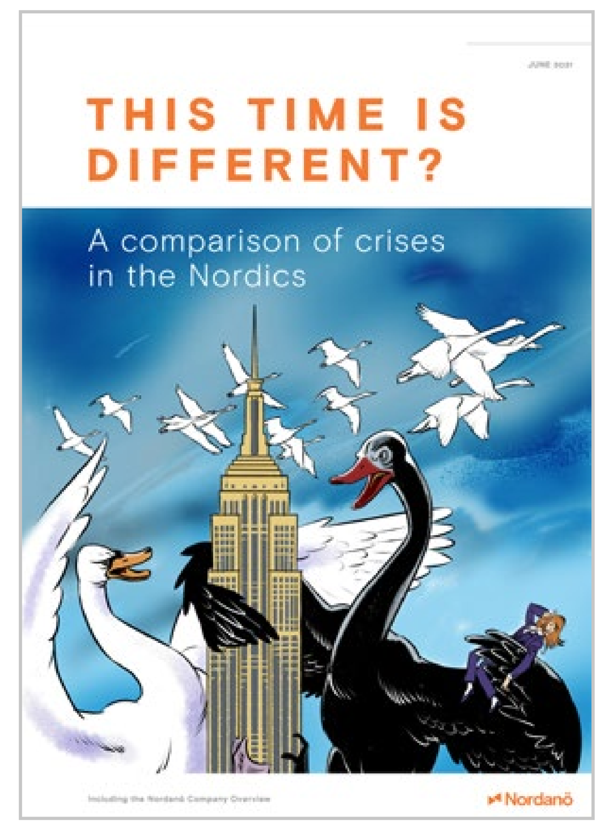

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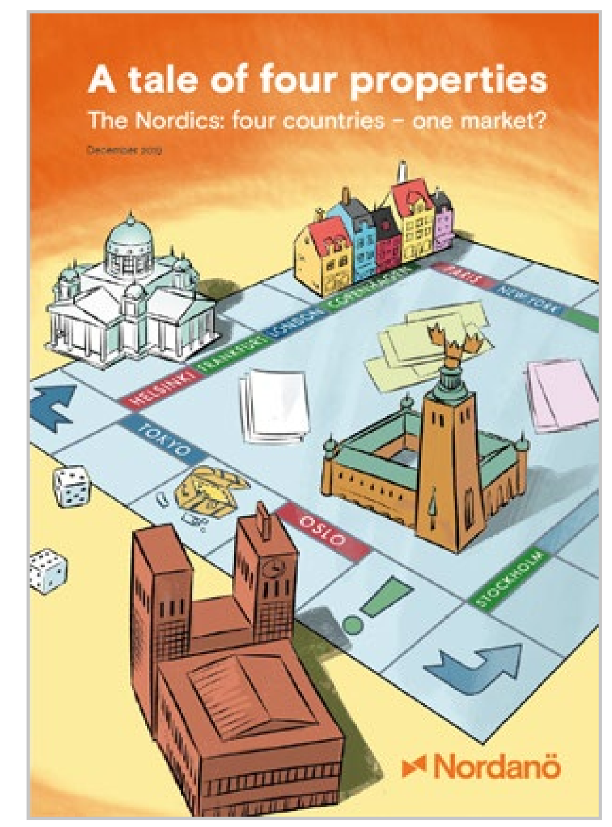

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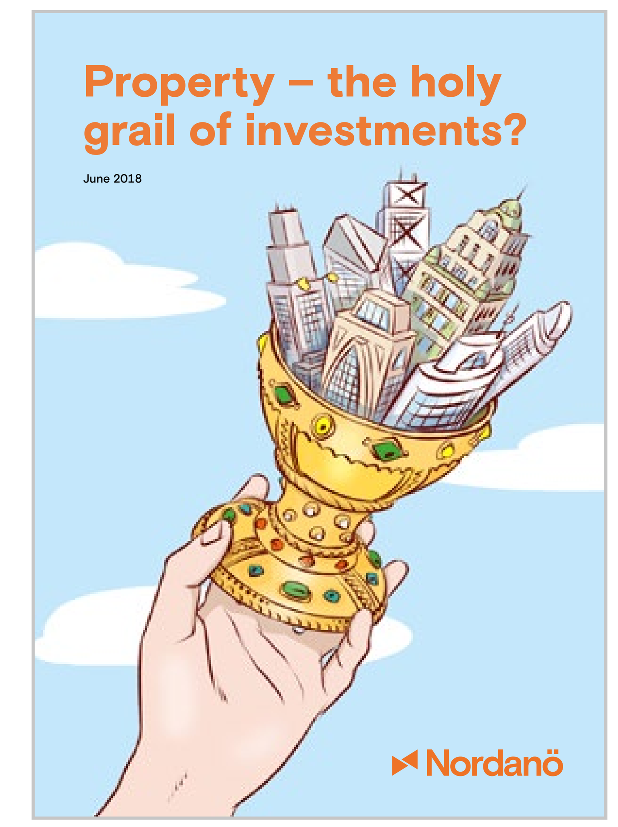

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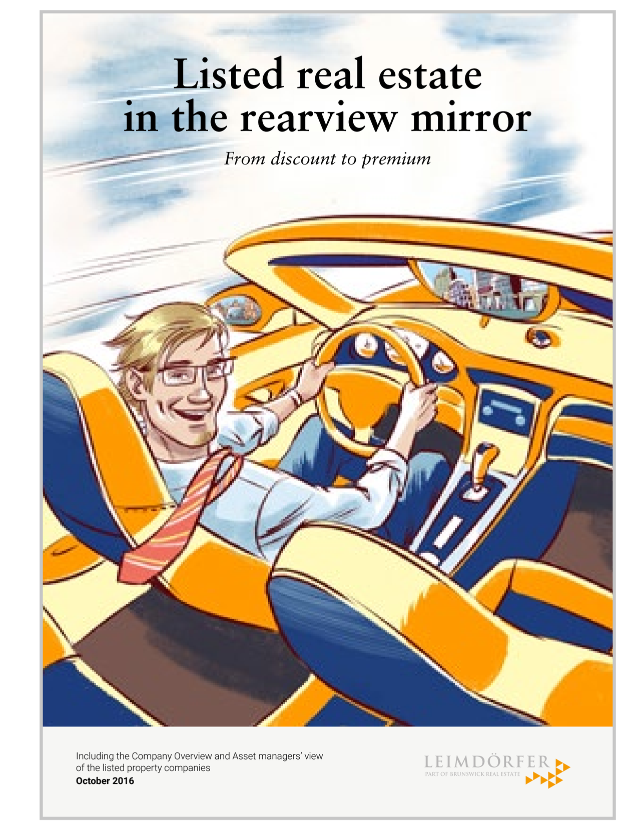

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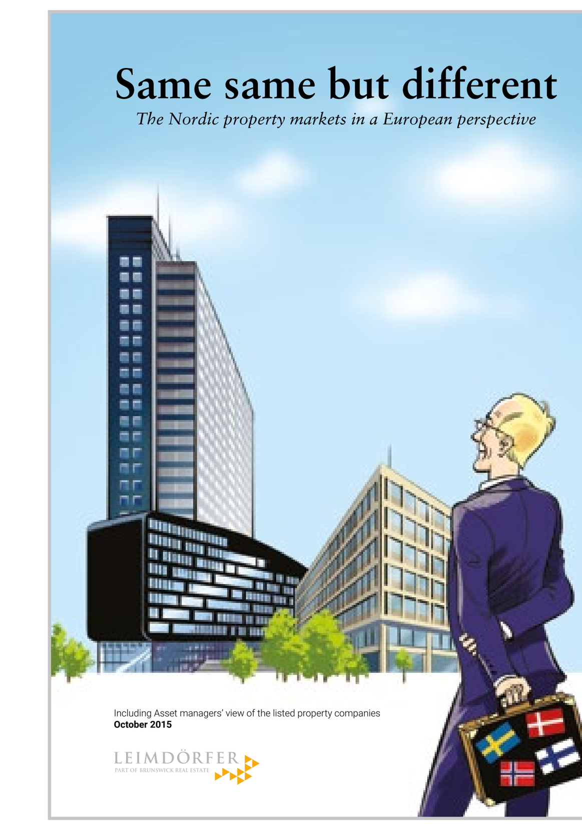

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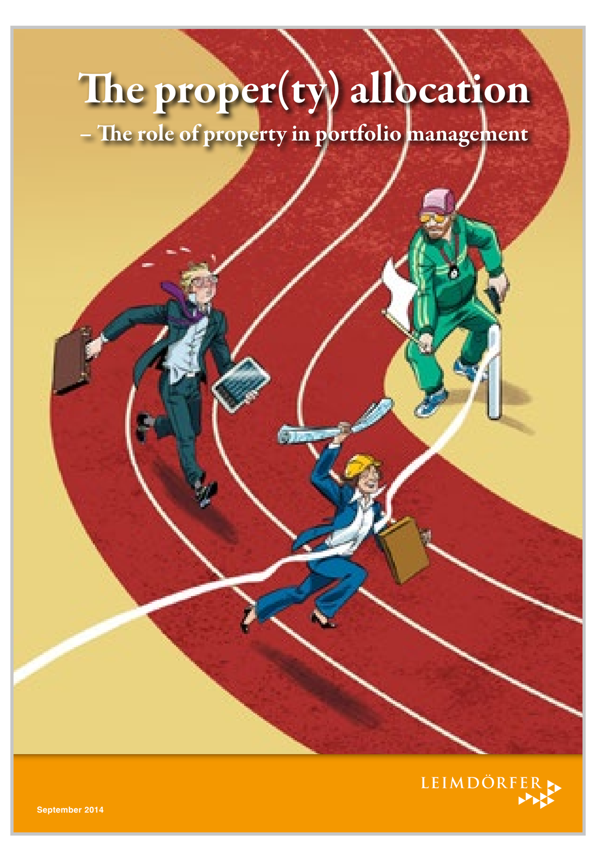

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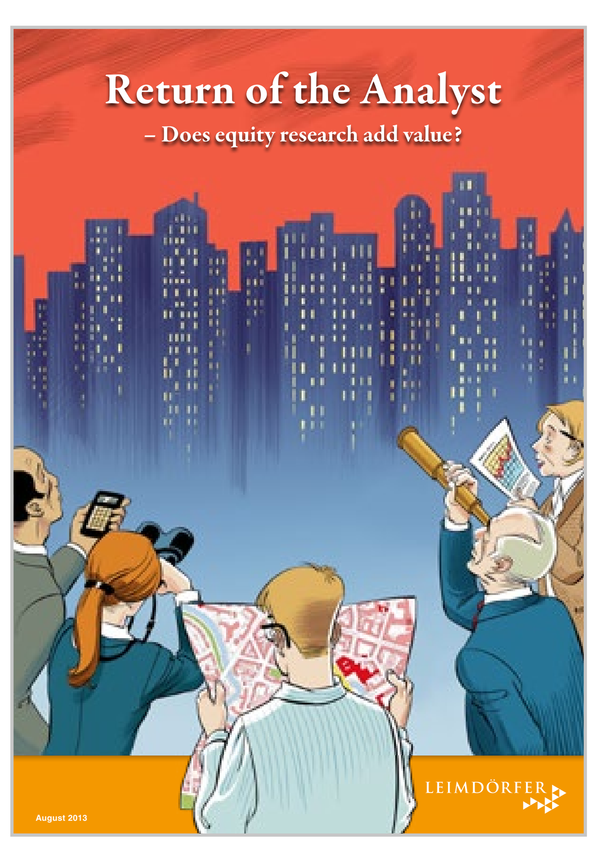

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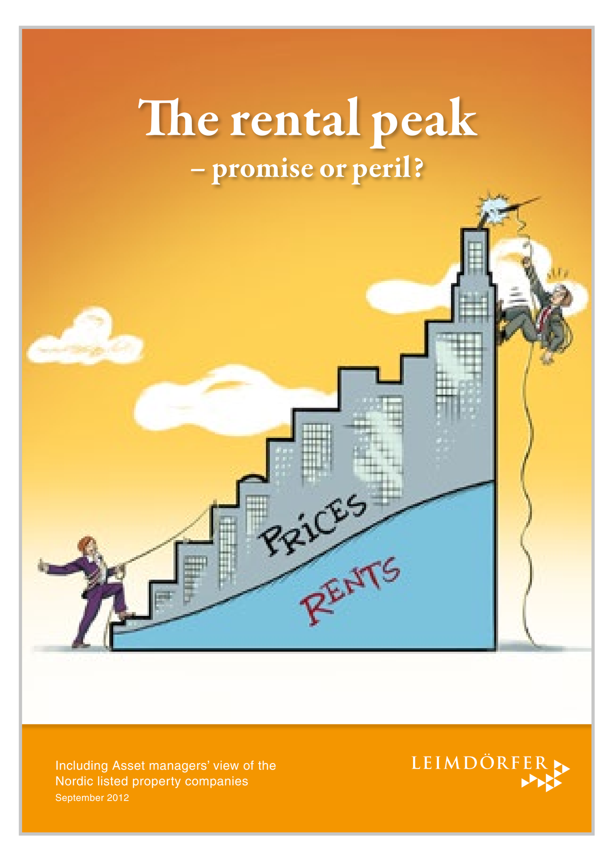

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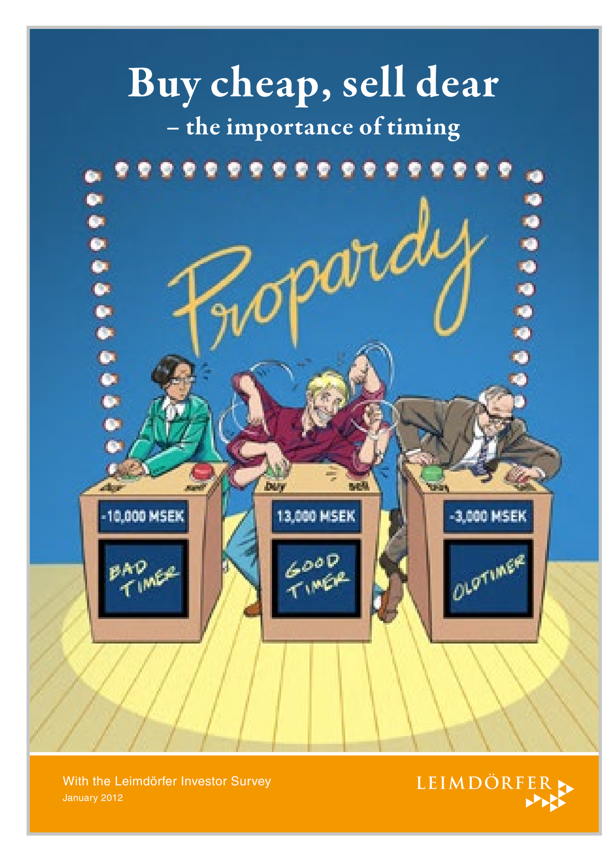

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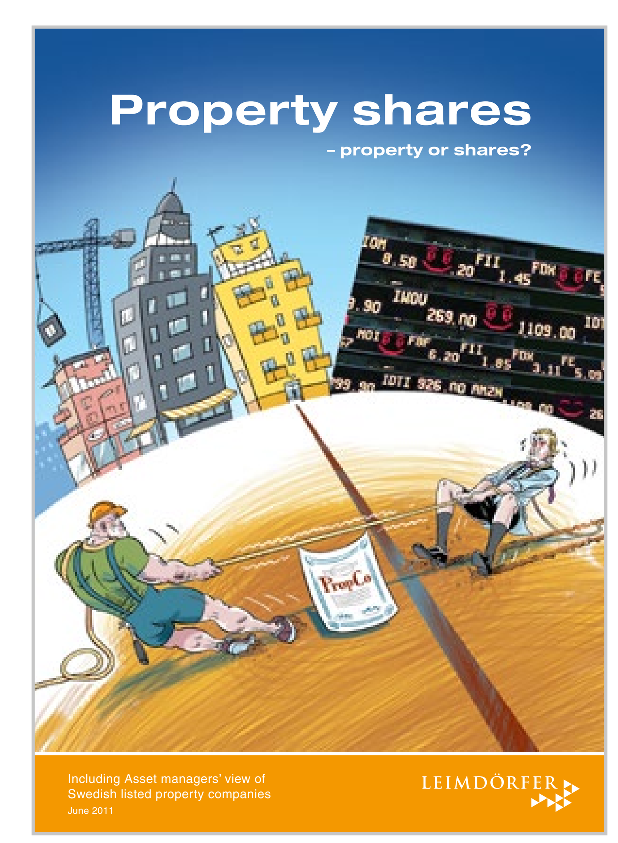

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