PwC-Immospektive

Interpretation of the FPRE Meta-analysis Real Estate 2Q/16

References to the FPRE graphics are indicated with "(1)" etc. in our text.

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Hope for a stronger Swiss economy in 2016 is dwindling and economic forecasts have only improved by 20 basis points compared to the previous year. Even immigration, which has served as a "lifeline" in previous quarters, is weakening and cannot support demand sufficiently. Nevertheless, real estate markets remain relatively stable in this difficult environment. The market for rental apartments as well as the office market are benefiting from the scarcity of investment opportunities for investors. With some imagination, investors are even finding attractive investment opportunities in the retail market.

Key points in brief:

- *Forecasts for Swiss economic growth in 2016 have been revised downwards*
- *Immigration has considerably slowed in 1Q/2016*
- *Scarcity of investment opportunities is supporting the construction sector*
- *Prices for private homes are increasing again, especially in the lower price segment*
- *Demand for rental apartments is falling*
- *Office rents have increased slightly. With the exception of Geneva, the supply rates in major cities are decreasing.*
- *The retail market remains difficult. However, adventurous investors are finding interesting investment opportunities.*

1.1. Economic uncertainty

The economic recovery has not yet materialised. Since GDP growth did not even reach 1 % in 2015, economists have corrected economic forecasts for 2016 downwards. On average, GDP growth rates of just 1.1 % are expected for 2016. In addition, hope for 2017 has weakened and GDP growth of 1.7 % is forecasted, compared to 1.9 % in the previous quarter. (8) However, Switzerland is not the only country facing this tough economic environment. US markets and the European market are struggling more than expected with their economic situation.

The subdued consumer sentiment will provide little substantial support to the economy. An unemployment rate of 3.6 % is expected for 2016 (8), and immigration has slowed. In 1Q/2016 the lowest immigration level since 2010 was reached with around 15,000 immigrants, which is about a third less than in the same period in the previous year. (12,13) At the same time, immigration from European countries has seen a particularly sharp fall.[1] Employment is not expected to grow in 2016, and forecasts are below 0.5 % which marks the lowest level for five years. (10)

After the repeated fall of the oil price, inflation forecasts were revised downwards. On average, economists (BAK, KOF; Créa, SECO, CS and UBS) are expecting a negative inflation rate of –0.6 % for 2016. The Swiss National Bank is even forecasting negative inflation of –0.8 %. The inflation rate is expected to stabilize at around 0.1 % in 2017. (8, 11)

[1] Credit Suisse Economic Research, Monitor Switzerland Q1 2016: More than an economic downturn?, March 2016

1.2. Low interest rates are supporting the weakening construction sector

Interest rates of –0.3 % for a 10-year Swiss government bond remain a helpful support the real estate market. (22, 23) Mortgage interest rates are moving in the same direction and are averaging at 1.7 % for a 10-year fixed-rate mortgage. (24) The ongoing period of negative interest rates is forcing pension funds as well as high net worth individuals to shift their investment strategy away from cash and towards a higher allocation in real estate property. The resulting scarcity of investment opportunities is motivating many real estate investors to invest in the building of rental apartments.[2] This seems to explain the sharp recovery of the indicator for economic activity in the construction sector, the CS/SBV construction cost index[3]. At –2 %, however, the index remains moderate compared to the previous year. (18)

1.3. House prices in the lower segment are increasing

After a sideways trend, the price indices for private residential properties are trending upwards again. Transaction prices increased signficantly in 1Q/2016 according to FPRE and IAZI. (54) This holds especially true for private condominiums as well as single-family houses in the lower price segment. In 1Q/2016, prices for private condominiums increased by 4.3 % and prices for single-family houses rose by 2.3 %. (49, 55) However, the situation is not the same across all regions. While the lower price segment of single-family houses has developed well, other segments continue to show a more modest trend. The demand in high-price segments around Lake Geneva, Lake Zurich and Lake Zug has been weakening for several years, which has forced the supply side to react. Approvals for construction projects have decreased, which has led to an improved or at least steady situation in most high-price regions.[2] Experts on the private housing market also report that developers as well as investors are increasingly meeting the changing requirements of the market. Smaller, high-quality condominiums which are more efficient in their use of space are increasingly being offered, which are easier to sell and can also be sold for higher prices per square metre.

1.4. Apartment buildings as a temporary solution

Despite high price levels and weakening demand, apartment buildings remain attractive for investors. Institutional investors are focusing especially on new developments, even though increasing vacancy rates are to be expected. Economists at Credit Suisse are now measuring a vacancy rate of 2.9 % in rural areas. A low vacancy rate of 0.5 % can now only be expected in major city centres, while suburban areas show a vacancy rate of 2.4 %.[2]

Market rents for apartments continue to decrease. The rents of newly built apartments in particular are dropping. (26) This development is roughly evenly spread between prime locations and central agglomerations as well as suburban and rural areas. (28) Nevertheless, real estate owners in almost all locations are still expecting increasing market values for 2016 and beyond. (34) This tendency is due to the declining yield requirements of investors. According to studies conducted by “CSL Immobilien”, the initial net return for class A locations (larger cities) and class B locations (regional centres) have on average decreased to a rate of 2.25 %. By contrast, the yields for rural areas are well above 3.00 %.[4] Despite low yields and falling rent prices, investors have few alternatives left. The scarcity of investment opportunities due to the low-interest environment is motivating institutional market participants to keep on investing in this asset class.

1.5. Market rents for office space are increasing slightly

The subdued economic forecasts and the anticipated slowdown in employment growth will provide very little support for the office market. In their current real estate market study, Credit Suisse is expecting stagnating demand for office space this year.[2] Among other factors, the three main drivers of the Swiss job market – structural change, offshoring and automation – as well as new ways of working such as desk-sharing and working from home, account for the missing additional demand.[5]

[2] Credit Suisse Economic Research, Real Estate Market 2016, March 2016

[3] Construction cost index, Credit Suisse and the Swiss Construction Associations.

[4] CSL Immobilien, Real Estate Market Report 2016, March 2016

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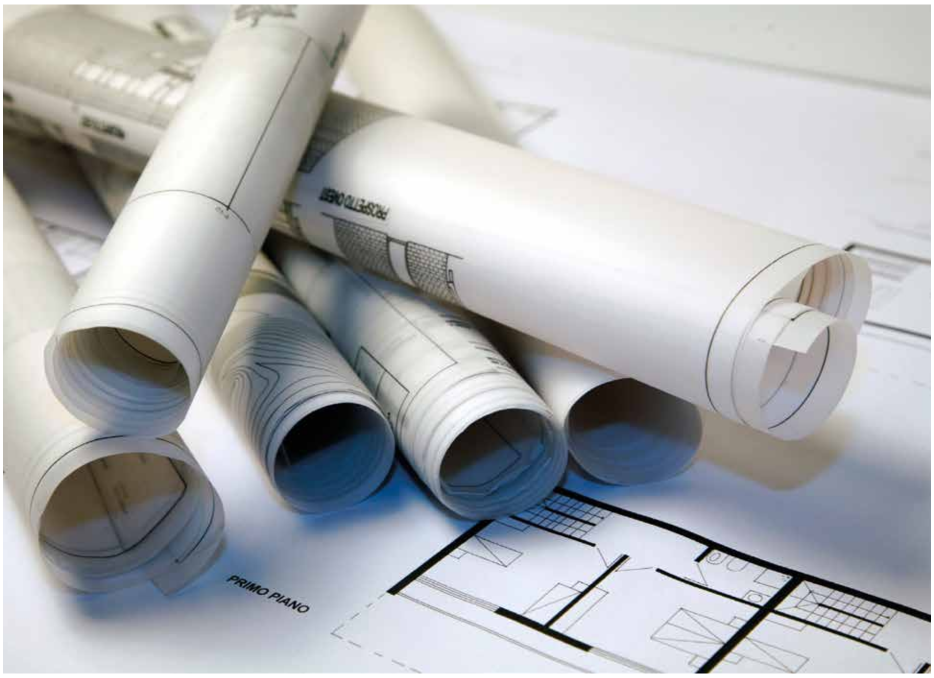
Despite weak demand, market rents for office space in the three largest urban centres, Lake Geneva, Basel and Zurich, have increased by around 2% quarter-on-quarter. (35, 36) However, market rents in the region around Geneva have decreased by around 9% compared to the previous year despite the positive development of the last quarter. In the Zurich region, market rents are almost at the same level as the previous year with a slight difference of –0.8%. In contrast, market rents in the region have increased by 3.2% compared to the previous year. Quoted rents have remained relatively consistent throughout the year. (35, 38)

The slight increase in market rents in the Zurich and Basel regions is connected to a decrease in the supply of office space. In Zurich, available office space decreased from 827,000 m2 to around 727,000 m2. In the economic region of Basel, available office space has decreased by more than half, from around 160,000 m2 to 74,000 m2.[4] In the region around Geneva, on the other hand, available office space has increased and accounts for 7% of the total existing office space. (39)

Due to the absence of attractive investment opportunities, the interest of investors in office properties is enduring – despite the difficult market situation, which gives little cause for optimism. Last years' trend of yield expectations is continuing. While initial net returns for class A and class B office properties are continuing to decrease and have reached a level between 2.75% and 3.5%, investors in class C properties are expecting initial net returns close to 7%, due to the increasing risk they are taking for such investments. (40) At the same time, this trend is drawing attention to the increased predatory competition in the office market, which is keeping investors from acquiring poorly connected properties or properties with outdated floor space concepts.



1.6. Retail only for risk-affinitive investors

The situation on the retail market remains difficult. Even though retail has recovered due to a positive population development and the slightly increased purchasing power[6], which is caused by growing real wages, this development is not expected to have any positive influence on the demand for retail space. Among other factors, this is due to the strong expansion of online retail and "shopping tourism" to neighbouring countries. These reasons are repeatedly named when retail branches are closed. Outside prime locations at big central stations or high streets, property owners still have to face high vacancy rates and weak demand. Accordingly, the forecasts for retail space paint a relatively bleak picture. CS, UBS and Wüest & Partner expect a decrease in retail rents of between 3% and 4% for the year in progress. (6) Nevertheless, this tough environment raises the interest of adventurous investors. Low revenues and the accordingly low revenue-based rents have led to falling prices for retail properties in the last year. Adventurous investors are counting on "bargain buys", and are hoping that an economic recovery after 2017 will lead to increasing rents.

[5] Schweizer Immobilienbrief: The E-paper of the Swiss Real Estate Industry, issue 07/2016, issue number 218
[6] NZZ, Schweizer Löhne 2015/16: Mehr im Portemonnaie, 22th April 2016