PwC-Immospective

Interpretation of the FPRE Meta-analysis Real Estate 1Q/16

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

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The Swiss economy will struggle to gain momentum until 2017. However, farsighted investors may benefit from this situation. While prices for residential properties may have peaked, office properties in well-developed "B" locations might offer good investment opportunities. The slow economic recovery will increase demand for such properties. Owners of retail properties are also waiting for this kind of recovery. So far, consumers have spent their savings from low energy prices at online retailers or at foreign locations close to the Swiss border.

Key points in brief:

- *The Swiss economy is facing 2016 with subdued expectations.*
- *Inflation in 2015 was at its lowest level since 1950, but domestic services prevented a deflationary spiral.*
- *The low interest rate environment is still supporting the Swiss real estate sector.*
- *The construction sector will have to face decreasing prices in 2016.*
- *The demand for private residential properties is decreasing, and condominiums are being redesigned as rental apartments.*
- *Housing rents are decreasing and the increase in prices for residential properties has reached its peak.*
- *Office properties in well-developed "B" locations might offer opportunities for far-sighted investors.*
- *Investments in prime retail properties are still in demand, although revenues are poor.*

1.1. Subdued expectations for 2016

22015 turned out to be the weakest year for Switzerland's economy since 2009 (9), and economists have subdued expectations for 2016. The forecast average GDP for 2016 is 1.2%, with growth roughly on a par with previous years before the lifting of the minimum exchange rate between the Swiss franc and the Euro. Growth is expected to pick up in 2017 to around 1.9%. (8) The lifting of the cap on the Swiss franc/Euro exchange rate was more than a "workout programme" for Swiss businesses. According to an assessment by Credit Suisse the removal of the cap in January 2015 has cost around 10,000 jobs. In particular, sectors such as retail, manufacturing and service providers have caused the unemployment rate to rise from 3.2% (year-end 2014) to 3.4% (year-end 2015).[1]

In 2016 the unemployment rate is expected to increase further to 3.6%.

Due to low prices for imports and commodities, the inflation rate of –1.1% in 2015 was at its lowest level since 1950. This was mainly due to lower prices for import and commodities. However, prices for domestic services have increased during recent years and have thus prevented a deflationary spiral.[1] Inflation forecasts for 2016 remain negative (the average forecast is –0.3%) (8) and the SNB is even predicting a negative inflation rate of –0.5%. (11)

Low interest rates have carried real estate investments throughout the economically difficult year of 2015. The interest rate curve remains below 0% up to the 10-year-bond. (23) The expectations of economists as well as the SNB are also located around 0% for 2016. (21, 22) Due to the expansive monetary policy of the European Central Bank (ECB), longterm interest rates are not expected to increase until 2017.[2]

[1] Credit Suisse Research Alert: Ein Jahr CH-Stärke – eine Bestandsaufnahme, 8.1.2016
[2] UBS: Real Estate Fokus, 2016

1.2. Prices in the construction sector will decrease in 2016

The indicator for economic activity in the construction sector, the CS/SBV-construction cost index[3], convincingly overcame an interim low in 4Q 2015. Positive stimuli came from building construction with +1.9% and from structural and civil engineering with +2.4% compared to the previous quarter. Nevertheless, the construction index declined by –4 % on a year-to-year basis. (18) The production cost index as well as the Swiss construction cost index remain negative and do not give the construction sector reason to hope for increasing prices in 2016. (19, 20)

1.3. Disciplining of the housing market

According to UBS, the inflation-adjusted prices for private residential buildings are at the same level today as during the peak of the housing bubble at the beginning of the 1990's. However, marketing is becoming more difficult and the expected stagnation of private incomes in 2016 will prevent further price increases.[2] Investors are adapting to the new environment. Many building projects are being redesigned from condominiums to rental apartments in order to take account of the increased demand for housing and the decreased demand for residential properties. Overall, the prices for private residential properties in Switzerland are trending sideways. Single-family homes in the middle segment are trading at lower prices compared to the previous quarter. However, prices have still increased 2.1% on a year-to-year basis. (47, 48) In general, high price levels are reducing demand. While the average size of apartments reached its peak in 2008, households are reconsidering their need for space today. Meanwhile, the average size of apartments is 10% below the peak values of 2008.[2] In addition, the demand for private residential properties in high-price regions has weakened as well. The price indices for the Lake Geneva region in particular have exhibited negative trends for the last three years. (51) Price growth in the Zurich region has slowed down as well. (50) By contrast, prices have risen in formerly affordable locations such as eastern Switzerland or the German-speaking central Switzerland.

1.4. Little potential for prices for apartment buildings to increase

Apartment prices decreased again throughout Switzerland in 4Q 2015. In particular, rents have decreased in southern Switzerland (–5.3%) as well as in the economic centres of Zurich (–2.1%), Basel (–2.0%) and the Lake Geneva region (–1.5%). The expectations for the development of housing rents remain negative as well. The majority of market participants expect declining rents over the next 12 months. (31) By contrast, expectations for the development of prices for apartment buildings are clearly positive. (32) There are hardly any rational reasons for further price increases. Most institutional investors have not been able to post positive increases in cash flows as of year-end. The published appreciations are predominantly due to decreased capitalisation rates. In today's market environment it can hardly be expected that the pressure on yields will increase and lead to a further rise in apartment building prices without substantial interest rate movements. Nevertheless, FPRE is expecting prices to increase again in 2016 and 2017. (5)

[3] Baukostenindex der Credit Suisse und des Schweizerischen Baumeisterverbandes.

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1.5. Office properties in "B" locations offer opportunities beyond 2017

As the Swiss economy is only recovering slowly, the level of office occupancy is also expected to increase at a slow pace. A need for additional office space of approx. 800,000 m2 until the end of 2017 has been calculated. This space will predominantly be covered by the construction of office projects that have already been planned.[2] This development is also reflected in the net initial rate of return for office properties. The net initial rate of return for office properties in prime "A" locations has decreased over the last seven years. By contrast, the return of properties in "C" locations has increased over this period. (40) While investors are satisfied with yields of 2.5 % – 3.0 % for prime locations and fully leased properties, yields of 6.0 % are demanded for difficult properties. With an economic recovery, secondary properties might achieve a positive turnover and yield opportunities for adventurous investors beyond 2017.[2] This applies particularly to good locations in medium-sized centres as well as to "B"-locations in economic centres. However, until then, some "lean periods" will have to be overcome. Office rents are still decreasing. While quoted rents remained at a constant level throughout 2015 (38), the rates of actual lease agreements have decreased substantially. For example, lease agreements declined by about 10 % in the Lake Geneva region and declined by more than 5 % in the Zurich region. (36, 37) For the time being, market participants remain sceptical with regard to office properties and expect prices to fall. (41, 42)

1.6. 1.6. Little prospect of rent-increases in the retail-segment

Retail properties have remained the "biggest headache" in the portfolios of real estate investors throughout 2015. Indeed, commodity prices have fallen and consumers should be left with more money to spend. However only the revenues of online retailers and the spending of Swiss nationals in foreign locations close to the Swiss border have increased. Alongside revenues, the rents for retail spaces in prime locations have suffered as well. In the economic centres of Zurich and Geneva, retail rents have collapsed to about CHF 1,000/m2.[2] Nevertheless, the megatrends are in favour of investments in retail properties in prime locations. Acquisitions in 2015 yielded top net returns of 2.5 %, even though any prospects of an increase in rents over the next two years were barely realistic.