PwC-Immospektive

Interpretation of the FPRE real estate meta analysis for Q1/20

References to FPRE graphics in our text are marked (1) etc.

The real estate market remains attractive in spite of the gloomier outlook for the economic environment as a whole

21 February 2020

Trade policy tensions are depressing the global economy and Swiss exporters need to learn how to deal with the sustained strength of the Swiss franc. Consequently, the outlook for 2020 remains moderate. On the positive side, low inflation is propping up domestic purchasing power and the low interest environment looks set to persist for the time being. These conditions will favour the owner-occupied housing market in particular, while returns in the rental apartment segment will come under increasing pressure. Office properties are benefiting from the tailwind of robust employment figures, and the problematic retail sector is reporting stable sales on the back of stronger purchasing power.

1. Economic forecast reveals only a few rays of sunshine

2019 will go down in the history books as the weakest year for the economy since the upheaval of the financial crisis in 2009. Growth fell well short of the growth rates seen in previous years at around 1 % [9].[1] Economic sentiment in Switzerland has barely changed since then. The economy continues to underperform, and political uncertainties and trade tensions persist. The coronavirus poses an additional challenge, although the ramifications are impossible to predict at the present time.[2] The Swiss franc continued to appreciate over the past twelve months, which maintained the pressure on Swiss exports. Thus, the economic prospects for 2020 remain moderate. The only reason why Swiss GDP expectations are up on 2019 at 1.4 % (previous quarter: 1.5 % [8]) is the fact that there are two sporting events on the horizon. Although political uncertainties are expected to subside in the medium term, the knock-on effect of any resurgence in the global economy will likely not manifest itself in GDP growth until 2021.[3,4] Accordingly, the forecast for Switzerland (with no major sporting events) is 1.5 % [8], but will fall short of the long-term potential growth of 1.6 % to 1.8 % for the time being [9].

Household purchasing power is improving

While goods exports and investments are softening in the wake of lower global economic output, the Swiss labour market continues to prop up the domestic economy.[4,5] Even though employment growth slowed slightly from the second to the third quarter of 2019, it is still 1.1 % higher year-on-year.4 In addition, employment is expected to remain robust in 2020.[6] Given these conditions, the unemployment forecast for 2020 has been scaled back further to 2.4 %, down from 2.5 % in Q4/19 [8]. Since the labour market lags behind the economy, unemployment is expected to rise slightly in 2021 (2.6 % [8]). Among the wider population, however, there has barely been any uptick in job insecurity.[3] Given the prevailing environment of low inflation expectations and rising real wages, household purchasing power looks set to improve further.[7,8]

[1] Swiss Life Asset Manager (SLAM), Perspektiven Konjunktur / Januar 2020
[2] SLAM, Perspektiven Konjunktur / Februar 2020
[3] Credit Suisse, Monitor Schweiz / 4.Q 2019
[4] Staatssekretariat für Wirtschaft (SECO), Medienmitteilung vom 12. Dezember 2019: Konjunkturaufhellung erst im Jahr 2021 erwartet
[5] Schweizerische Nationalbank (SNB), Quartalsheft 4/2019 Dezember
[6] Wüest Partner, Immobilienmarkt Schweiz 2019/4
[7] SECO, Konjunkturtendenzen / Winter 2019, 2020
[8] Konjunkturforschungsstelle KOF, Konjunkturanalyse / Prognose 2020, 2021: Schwächephase hält an

2. Inflation expectations take a further dive

In 2019 the rate of price increases was 0.4 %.[5] For 2020 the forecast from the economic institutes has been downgraded to 0.2 % for the time being, due among other things to falling energy and import prices (0.5 % in Q4/19) [8].[2] The SNB is even forecasting an inflation rate as low as 0.1 % in 2020 [11]. Several central banks have loosened the reins of their monetary policy in recent months. It can therefore be assumed that key interest rates will be kept at a low level for the time being.[9] However, inflation will likely rise as a result in the medium term.[5]

10-year bonds have stabilised at around 0.5 %

The SNB key interest rate remains unchanged at 0.75 %, with the Swiss National Bank following the prevailing economic trend and likewise extending its expansive monetary policy.[5] The interest rate forecast for the 3-month Libor has, however, risen by 10 basis points from -0.8 % to -0.7 % [21]. After hitting a low in October 2019, the yields on Swiss government bonds have started to climb again. 10-year sovereigns stood at -0.53 % at the beginning of January [20, 22]. This trend was mirrored by the government bonds of various major economies [73]. Swiss 3-year and 10-year mortgages also increased slightly, up in December to 1.1 % and 1.3 %, respectively [23].

3. Civil engineering remains the main driver of the construction sector

Investing in construction remains attractive, bolstered by the favourable interest rate and inflation outlook.[6,9] The construction index was practically unchanged quarter-over-quarter in the fourth quarter of 2019 at 151 points (+0.8 % vs. Q3/19) [17]. Civil engineering remains the main driver of the construction sector (+2.1 % vs. Q3/19), with building construction and especially residential construction (-3.6 % vs. Q3/19) exhibiting increasing signs of saturation.[10] Like in 2018, 2019 saw a further decline in the number of building permits issued for new homes. Rising vacancies and the longer time taken to be granted a permit are playing a role here. Stricter requirements in terms of environmental protection, urban densification and regulatory conditions have lengthened the permit process for multi-family dwellings by 60 % since 2001.[11]

Commercial construction records high order volumes

Within the building construction sector, commercial construction (+2.6 % vs. Q3/19) made a positive contribution to revenue growth due to a healthy construction pipeline. This growth is expected to flatten out going forward, however, on the back of ongoing weak economic activity.[10] The KOF Swiss Economic Institute forecasts that building construction will continue to lose momentum as a result of the recent weak population growth and rising vacancies, and that the construction sector will be propped up by investments in infrastructure in particular.[8]

4. Property prices on the rise

The prices of owner-occupied homes have been increasing disproportionately to the national consumer price index since 2008.3 Since construction activity within residential construction continues to be driven by rental apartments and there has been a further pickup in demand on the back of the attractive financing environment, the prices of owner-occupied homes are still on the rise.[6,11]

In the Zurich region, owner-occupied apartments spiked by 4.7 % in Q4 2019 alone.

Prices have risen nationwide year-on-year (Q4 2018), both for owner-occupied apartments (+7.9 % [3, 56, 57]) and – albeit less so – for single-family homes (+1.5 % [4, 50, 51]). In both categories, this trend is especially pronounced in the premium price segment (owner-occupied apartments +13.6 %, single-family homes +1.9 % vs. Q4/18). On a regional basis, only the prices of single-family homes in southern Switzerland posted a negative performance (-2.9 %).

Owner-occupied apartments in particular continued to trend upwards in the final quarter of 2019, rising 2 % on the quarter before; single-family homes were up a more modest 1.1 %. In regional comparison, the sharpest increase in housing prices was recorded in the Zurich region, at 4.7 % for owner-occupied apartments and 1.3 % for single-family homes. Prices

[9] CSL Immobilien, Immobilienmarktbericht / Februar 2020
[10] Credit Suisse, Bauindex Schweiz / 4. Quartal 2019
[11] Zürcher Kantonalbank, Immobilienbarometer / 4. Quartal 2019
[12] FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 31. Dezember 2019

also made above-average gains in the Geneva region (2.6 % for owner-occupied apartments [58, 59] and 2.1 % for single-family homes [52, 53]). By contrast, housing prices underperformed in the Jura region (-0.2 %) and southern Switzerland (-0.7 %).[12] This uptrend is expected to hold strong for both owner-occupied home categories [54, 60].

5. Apartment rents exhibiting long-term downtrend

In the case of residential investment properties, a mild downtrend has been under way for five years now [25]. While markets rents (transaction rents) staged a temporary recovery in Q3 2019, they were down year-on-year.[13] Then, in Q4 2019, rents fell again in all regions of Switzerland by a further 2 % [26]. This is equivalent to a year-on-year decline of 0.5 %. The biggest fall was in southern Switzerland (-3.5 % vs. Q3/19, -5.3 % yoy vs. Q4/18), while the smallest was in Jura (-0.6 % vs. Q3/19, +0.6 % yoy vs. Q4/18) [25, 26].[14]

Apartments in older buildings recorded the sharpest drop in rents in Q4 2019 versus Q4 2018, down 0.8 %; this is compared to -0.2 % for new apartment builds. Rents in both apartment categories trended downwards to an equal degree in the fourth quarter of 2019, at -2 %.[14]

Urban centres benefiting from accessibility and rental preferences

Most market players expect rents to remain on the decline. [30] According to their forecasts, only apartment rents in or close to urban centres will increase, since microlocation – specifically the quality of connections to the public transportation network – is the decisive factor for renters when choosing an apartment. When viewed as a whole, any fall in rents in a region is often due to outlying areas. Rents outside of urban centres fall more sharply than those in well-connected locations.[9] Accordingly, the average real discount rate for a mid-range new residential property in a prime location in Zurich is 2.03 % (2.06 % in Q4/19) [34], in Geneva 2.3 % and in Basel or Berne 2.5 %, whereas in the respective regions surrounding these cities a discount rate of 50 basis points more is assumed.[15]

With construction activity expected to remain strong and vacancies predicted to rise in 2020, rents are likely to trend downwards overall.[6] The vacancy rate rose from 1.62 % to 1.66 % in 2019, with a further increase on the cards in 2020.[9] In addition, the reference rate is forecast to decline further to 1.25 % this year; this is also likely to affect rents subject to an ongoing lease agreement.[11] Real estate investors anticipate rising property prices overall in the foreseeable future, owing to a lack of attractive investment alternatives and in spite of poor rental performance. [30, 31]

6. Rents for office spaces up for the seventh quarter in a row.

There is brisk demand for office spaces in inner cities, while properties outside of urban centres are exhibiting high vacancy rates. Outlying office spaces are coming under additional pressure due to new builds on the outskirts of urban centres.[16] In autumn 2019 around 7.3 % of all office spaces were vacant, although the solid employment growth in recent months has had a positive impact on vacancy rates.[7] While the economic slowdown will likely result in less additional demand and the construction activity is expected to decrease as well, vacancy rates should remain steady.[3,16]

An increase of more than 10 % was recorded on the previous year Swiss-wide

Market rents (transaction rents) for office spaces have been reflecting the dynamic rise in office employment since spring 2018. Rents increased by 1.6 % Swiss-wide in the final quarter of 2019, up 10.3 % on Q4 2018 [2, 35, 36, 37]. This positive momentum is evident in particular in Central Switzerland, where rents were 2.5 % higher than Q3 2019 and 13.4 % higher than Q4 2018. Office rents in the regions of Basel (+11.9 %) and Zurich (+11.4 %) were likewise up on Q4 2018. At the cantonal level, Zug was the only canton to see a decline in market rents, down 12.6 % on Q4 2018 at the end of 2019. Rents in the

[13] FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 30. September 2019
[14] FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 31. Dezember 2019
[15] PwC Investor Survey, Volume 10 / Oktober 2019

canton of Basel-Stadt posted the strongest increase viewed over the same period (+17.9 % yoy).[14] This means that, according to the investors surveyed, returns in the Zug region at 2.5 % are only slightly higher than in the Zurich region at 2.4 %. In the case of properties in prime locations in smaller cities such as St. Gallen or Lugano, the expected return is 3.2 %. An additional premium of 0.6 % to 1 % is being applied to properties in less attractive business locations in agglomerations compared with properties in downtown locations.[15]

7. Quality of location divides the market for retail space like no other segment.

At high-street locations, experts forecast that returns will be compressed in 2020 and thus that real estate prices will climb. The cause of this compression is not so much the retail segment as it is the central location and the good usage mix of office and residential space. Investors put the returns on A-class properties at their lowest in the city of Zurich at around 2.4 %, followed by the city of Geneva at 2.5 % and then the city of Lucerne at 2.7 %. As far as market rents are concerned, experts anticipate falling values in all major Swiss cities.15 The ongoing process of structural change in the market for retail space is resulting in high vacancies outside city centres.[17] Retail spaces at peripheral locations and increasingly also in shopping centres and retail parks are viewed very critically by investors, if not avoided completely.[15]

Thanks to weak yet stable population growth [12, 13, 14] and sustained purchasing power, sales in the retail segment remained stable in 2019 overall. While the clothing sector saw sales contract by 6.7 % (in real terms), in other segments they trended higher, for example in healthcare (+3.9 %) and leisure (approx. +3 %). Convenience stores and service stations have posted an especially pleasing performance over the last 10 years, with revenue up about 36 % since 2010. The presumed reason for this positive development is their usually flexible store concepts with longer opening times. More flexible and innovative models are needed to counteract the problem of rising vacancies in the retail market .[17]

Pop-up concepts can be part of the solution, but not all of it

Given real estate investors' scepticism towards retail properties, numerous spaces are left unused and rented as restaurants or offices. Only around 20 % of all retail spaces that become vacant in a mixed-use property are handed over to retailers again. Just like in the market for office space, there is an increasing desire for more flexibility in terms of rental conditions and legal frameworks. More and more pop-up models are emerging, for example. Concepts like these make it easier to test out new products and services or get someone into the available space on a short-term basis, and can give a fresh boost to a retail space's attractiveness to potential buyers. But while analysts say pop-up stores may offer a good solution for locations with a lot of foot traffic, they do little to solve the vacancy problem in peripheral locations.[17]

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[16] Credit Suisse, Büroflächenmarkt Schweiz 2020 / Dezember 2019
[17] Credit Suisse, Retail Outlook / Januar 2020