PwC-Immospektive

Interpretation of the FPRE meta-analysis Real Estate 3Q/16

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

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Although Brexit has had little impact on the Swiss economy to date, economic growth remains weak. Economists have not yet incorporated the potential influence of the British referendum in their forecasts, and they expect a gradual improvement in economic growth in the second half of the year. The real estate market in Switzerland is still benefiting from low interest rates, which should pave the way for a further reduction of the interest reference rate in 2017. The lack of alternatives particularly supports apartment building prices, which may increase again in the next two years. However, the office market is becoming increasingly demanding, while the retail market is still struggling with the economic situation.

Key points in brief:

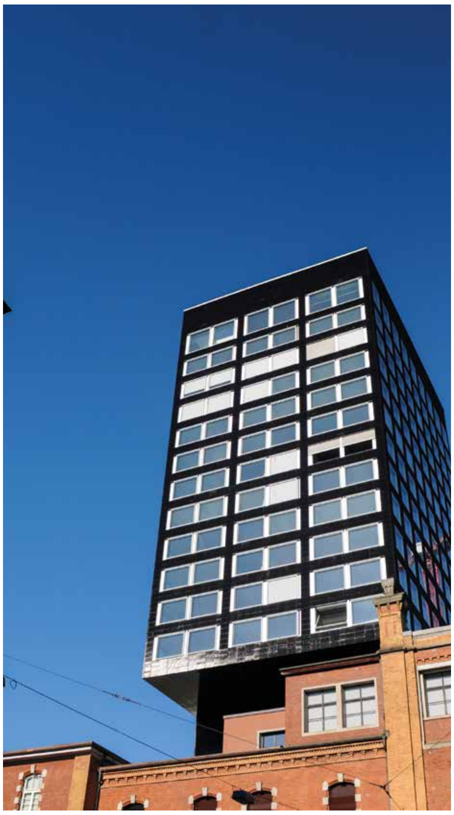
- *Brexit has had little impact on the Swiss economy to date*
- *Immigration in the first half of 2016 was around 20 % lower year-on-year*
- *Inflation and interest rates remain at a low level, paving the way for a further reduction of the interest reference rate in 2017*
- *The rising construction index indicates better prospects for construction activity, but prices may decline*
- *House prices are only increasing in the lower segments*
- *Interest in rental housing is increasing, and the economic environment supports a further rise in apartment building prices*
- *Office rents are continuing to decrease, and an additional increase in vacancies is inevitable given the new rate of construction activity*
- *Decreasing retail sales are diminishing hopes of an early recovery in the retail market*

1.1. Brexit has not slowed down the economy so far

At the beginning of the summer, Brexit caused a stir throughout Europe. While the UK has returned to a mood similar to that of the financial crisis and a sharp decline in economic growth is expected, the effects outside of the UK have not been felt as strongly. The economic recovery in the euro zone has continued and supported Switzerland, despite the strong franc.[1] Even though the situation in Switzerland has not deteriorated due to Brexit, Swiss economic growth is weak and is expected to recover only gradually in the second half of the year.[2] The forecasts for the current year do not yet reflect the latest events, and on average have been corrected slightly upwards. While KOF and BAK have raised their forecasts for 2016 compared to the previous quarter, UBS and Créa remain less optimistic.

On average, expected GDP growth in Switzerland in 2016 is 1.2 %, which is significantly below its potential longterm growth of 1.6% to 1.8%. The outlook for next year is closer to the country's potential growth, with figures averaging 1.6% (8, 9).

The currently weak economy is also affecting employment. The employment growth forecast of 0.5% in 2016 is at



its lowest level since the crisis year of 2009 (10). The unemployment rate outlook of 3.5% in 2016 (8) is slightly more positive than in the last quarter. However, the slight economic upturn in the second half might not be sufficient to further support the labour market.[2] An average unemployment rate of 3.6% is therefore expected in 2017 (8).

[1] SwissLife Asset Managers, Economic Outlook, August 2016
[2] UBS Outlook Switzerland, 3rd quarter 2016, July 2016

Immigration remains well below last year's level, with 5,000 people arriving in May and around 4,300 people in June (13). This year, immigration has decreased by 20% compared to 2015. Extrapolated to full year, immigration should amount to less than 60'000 people in 2016.[3] However, as asylum applications are likely to increase this year, a structural change in immigration rather than a very sharp decline should be expected.[4]

1.2. Low inflation and interest rates permit a further reduction of the interest reference rate in 2017

The rise in oil prices this year has reduced the pressure on consumer prices, which is reflected in inflation expectations. Economists have adjust their inflation forecast for 2016 from –0.6% to –0.4% (8). The SNB now estimates an inflation rate of –0.4% rather than –0.8% (11). The institutes expect a slight increase in inflation of 0.2% for the coming year (8).

The interest rate situation continues to support direct and indirect real estate investments. Meanwhile the entire yield curve including 30-year maturities is in negative territory. Only 1-year bonds are showing a slight increase (23). The interest rate expectations of economic institutes and the SNB with regard to 10-year government bonds range from –0.3% to –0.5% for the current year after further downward corrections (21, 22). The SNB has supported the Swiss Franc since the Brexit vote; however, if the upward pressure on the Swiss Franc persists for a longer time, further reductions in the interest reference rate will become necessary. So for now, a sustained increase in interest rates is far off.[2] Experts at Credit Suisse expect a further reduction of the interest reference rate in the summer of 2017 – or at the latest, autumn. This should lead to a bottoming out of the interest reference rate.[4]

1.3. Mixed outlook for the construction industry

The CS/SBV Construction Cost Index[5] – indicator for the economic activity of the construction industry – has continued to recover in the low interest rate environment. Due to large orders in the area of underground civil engineering, stronger demand in rental housing as well as numerous orders from public authorities, the index was able to rise above zero in the second quarter of 2016, creating hope for positive construction activity (18). However, the Swiss Construction Price Index decreased in the first quarter of 2016 by 0.5% year on year, indicating lower actual market prices in the construction industry (20).

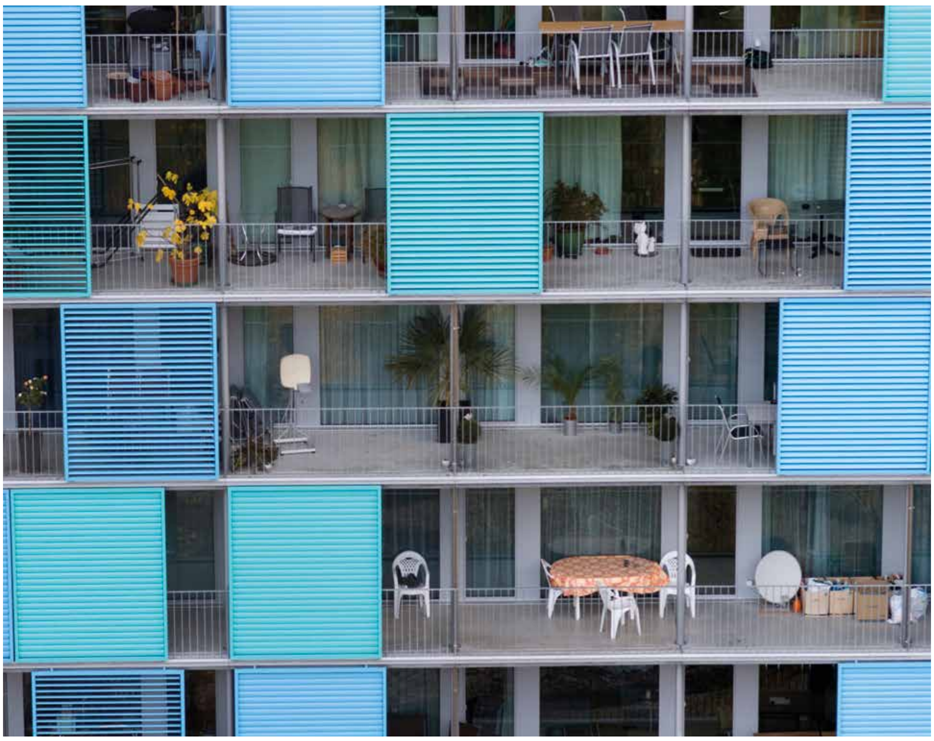
1.4. Strong demand for home ownership only in the lower price segments

After a temporary increase in the first quarter of 2016, the price trend for condominiums is decreasing across Switzerland, falling by 2.9% (3). The reason for this includes falling prices in the middle and upper segment, which have been struggling for more than four years with declining price dynamics.[4]

In the lower segments, prices have increased by 0.9% compared to the previous quarter (54, 55). According to FPRE-price indices, single-family houses are trading at a more expensive level in general, with a plus of 1.0% compared to the previous quarter. Cheaper properties especially are showing an increase (49).

The shift in demand towards the low-price segment is partly due to more stringent capital requirements in mortgage lending, which makes purchasing high-priced properties more complicated despite persistently low interest rates. At the same time, slow income growth and lower immigration levels of solvent foreigners are having a negative effect on the sale of upscale residential properties.[4]

This trend is being felt in particular in the two upscale regions: Zurich and Lake Geneva. The shift of interest toward lower-cost regions has caused a stagnation or decline in prices in the two basins (51, 56, 57). Construction activities are adapting to this trend: Around the lakes of Geneva, Zurich and Zug, the construction of properties is dropping significantly.[4]



[3] NZZ, Franken-Schock bremst Einwanderung, 5. July 2016
[4] CS Real Estate Monitor Switzerland, 2nd quarter 2016
[5] Construction Cost Index, Credit Suisse and the Swiss Construction Association

1.5. A further rise in prices for apartment buildings is possible

The run on residential properties as an investment opportunity continues and might even increase further. Due to a lack of investment opportunities in existing properties, the boom in rental apartments continues – despite the barely rising demand. In the context of weak immigration, economists at the two major Swiss banks UBS and CS have detected an increase in vacancy rates. UBS expects an increase in the vacancy rate throughout Switzerland from 1.2 % currently to 1.4 % this year.[2] While the influence on vacancy rates remains moderate, the differences in the development of the supply and demand side for rental housing will have a stronger influence on the development of market rents. So far, investors have been spared from a reduction in market rents. Contrary to subdued expectations, market rents have increased surprisingly in almost all regions, especially in the old building segment, compared to the last quarter (27). This increase is especially noticeable in the regions of Lake Geneva (3.6 %), Zurich and Basel (each 2.9 %) and Jura (3.1 %) (26). Asking rents have not retraced the positive trend of transactional market rents and instead have primarily experienced a further decline, especially in the Lake Geneva region (29, 30).

Given the increasing discrepancy between supply and demand as well as a possible further reduction of the interest reference rate in 2017, an increase in residential rents in the near future remains unlikely. Forecasts for the development of rental prices therefore remain slightly negative (5), even though the price expectations index has picked up slightly since the beginning of the year (31). Due to low interest rates and low return expectations, along with a still positive development of rents, there is still optimism that prices of apartment buildings may rise in 2016 and 2017 (5).

1.6 No positive impulses for the office market

The economic environment for the office market has deteriorated again since the beginning of the year, given the lower levels of immigration and weak employment growth. The index of vacant positions decreased by 8.5 % compared to the previous year. Contrary to this development, financial and insurance services have shown exceptionally strong development, and the number of vacant positions has increased by 14.3 %. The IT industry has shown a similar development, with an increase in vacant positions compared to the previous year (10). Despite the slowing demand, construction activity remains relatively high. Due to a lack of

[6] JLL Zurich Office Market Profile – Q2 2016; JLL Geneva Office Market Profile – Q2 2016

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alternatives, investors are still showing strong interest in the development of office buildings and are not discouraged by an increasing vacancy rate. Within the next 12 months, a further increase in vacancies is expected in the two main economic regions of Zurich and Geneva.[6]

After a brief price increase in the first quarter of 2016, market rents for office spaces are declining as expected. Only greater Geneva has recorded a slight increase (0.6%), due to a stabilisation of the recent supply rate. In the Basel region (–5.7%), in particular, followed by the Mittelland (–4.5%), rents are dropping noticeably. In Zurich, the decline amounts to 2.2% (36, 37). The asking rents do not yet reflect this trend and have trended sideways in the last quarter (38).

There are no signs indicating an imminent rise in office rents. The price expectation index for office rents was significantly negative in the second quarter. According to recent surveys, almost 70% of experts expect a moderate or severe decline in rents (41).

1.7. In the retail market, only the food sector has potential

Retail has still not recovered from the shock caused by the decoupling of the Swiss franc from the euro and is still coping with sale losses. The declining productivity of the retail trade is having an increasing impact on the revenue-linked rents of the retail industry. Compared to the previous year, rents for retail spaces fell by almost 7%.[2] Although the vacancy rate is currently at a relatively low level, an increase should be expected due to the lack of demand.

Even the weaker construction activity in the retail sector cannot slow down this development. Due to these circumstances, the marketing of retail spaces is becoming more uncertain.[4] This applies especially to locations with a low pedestrian frequency and poor accessibility. The most recent branch closures of renowned retailers and the shift of business towards online retail has illustrated the difficult situation in the retail property market. Only the food and nearfood sector still offer a positive outlook due to the stable growth of the population.[4]