PwC-Immospektive

Interpretation of the FPRE real estate meta-analysis Q4/16

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

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Economists are still sceptical about the recent recovery of the Swiss economy and warning against premature euphoria. Investment in homebuilding driven by negative interest rates is supporting construction, and the construction index has leapt up. Net yields have therefore reached a new record low, despite the increased space on offer and falling rents. Declining sales, especially in non-food, are putting pressure on sales-based rents and the market value of retail stores.

Key points in brief:

- *The economic recovery is based on volatile components and should be interpreted with care.*
- *Immigration in the first half fell to its lowest level since 2010.*
- *The change in the trend in inflation was due to higher prices for heating oil and petrol.*
- *The most recent upward move in yields has not yet been reflected in economists' forecasts for interest rates.*
- *The real estate industry is building a large number of rental apartments and the construction index has jumped to a record level of 144.*
- *Net yields on multifamily homes in Zurich have slipped below 2%.*
- *The market for owner occupation is returning to normal.*
- *The rental apartment market is tending towards oversupply, putting pressure on rents.*
- *Office space is being leased out at much lower rents, but supply figures are falling in the major cities.*
- *Lower sales in non-food are weighing on sales-related rents in the retail sector and will lead to writedowns at the year-end.*

1.1. Modest prospects in spite of surprising growth

Contrary to expectations, the first half of 2016 saw a recovery of the Swiss economy. In the second quarter growth was 0.6%, up from an already strong 0.3% in the previous three months. As a result, the latest GDP forecasts for the current year are more positive than was expected in the first half.[1] In particular, CS (1.5%) and BAK (1.6%) raised their expectations sharply. The average forecast is for GDP growth of 1.5% in 2016. As was the case last quarter, forecasts for next year are at 1.6%. (8,9)

Economists are warning against premature euphoria, however. A closer look at what is driving the economy reveals that the largest share of the growth is coming from inventories and government expenditure, which are volatile components. Private consumption and domestic private investment are falling. At the same time, the rise in export volumes in the first half is almost solely due to the strong growth in chemical and pharmaceutical exports.[2] Immigration has been weak since the start of the year, at an average net rate of about 5,000 people per month, and hence at present is unable to drive consumption or support economic growth. (13)

The employment figures do not show a positive trend either: the forecast growth for 2016 is tending towards almost zero. The expectations for 2017 are also modest at just under 0.5%. (10) When it comes to forecasts for unemployment figures, growth has made economists somewhat more optimistic: the institutes are now expecting unemployment to average 3.3% for 2016 and 3.4% for 2017. (8)

Growth expectations are still volatile in light of the global political and economic uncertainties. Recent and upcoming political decisions such as the US elections, implementation of the mass immigration initiative and Brexit will not remain without an impact on the economic situation in Switzerland.

1.2. Interest rate forecasts cut again

The increase in prices for petrol and heating oil in particular is encouraging economists to predict positive inflation once again in the coming months, after two years of deflation. This is likely to be relatively restrained, however, given the SNB's slightly reduced expectations of 0.2% for 2017 and 0.6% for 2018. (11) The forecasts from the economic institutes are slightly more positive for next year, averaging 0.4%. (8)

[1] SwissLife Asset Managers, Economic Outlook, October and November 2016
[2] Swiss National Bank, Quarterly Bulletin, 3/2016, September 2016

The SNB's policy decision of 15 September 2016 made clear its intention to stick to monetary expansion.[3] In spite of the sharp increase in yields in October, the entire yield curve remains in negative territory. (22) These recent movements have not yet been incorporated into economists' forecasts, and compared to the previous quarter they have once again cut expected interest rates for next year to around –0.4% (KOF). (20)

1.3. Construction index hits record high

The CS/SCA construction cost index leapt to a new record high of 144 in the third quarter of 2016,[4] not only continuing the positive trend of the previous quarter but showing a clear acceleration, rising 13% year on year. Whereas civil engineering was the main upward driver last quarter, now it is construction, especially residential construction, that is showing the strongest growth at 17% year on year. (17) Applications for building permits remain high, so this trend is likely to continue over coming quarters. The number of building permits rose 5.5% between September 2015 and August 2016. The renewed vigour in construction, especially residential construction, is mainly due to the negative interest rate policy, which has made real estate a much more attractive asset class over the past 18 months. However, the persistently strong investor interest is in contrast to the declining demand on end-user markets – a trend that is likely to bring risks for the construction industry in the medium term.[5]

1.4. Owner occupation market coming back into balance

Price momentum continues to weaken in the owner occupied market, especially in the high and medium-priced segments. This trend is most pronounced in single-family homes – transaction prices slumped by an average of –3.9% (47) quarter on quarter, with the strongest declines at the top end: –4.5%. (48) Prices for owner occupied apartments are trending sideways at the moment according to the FPRE price index, and the last significant move upwards was in the first quarter of 2016. (53) The lower end is still seeing an uptrend, rising 2.7%. (54)

In regional terms, the demand for owner occupied apartments is continuing to shift away from the expensive areas around Lakes Geneva, Zurich and Zug towards cheaper regions such as Central Switzerland and the Jura. (49, 50, 56) With the exception of the mountain regions, which are still suffering from the effects of the second homes initiative, most of the cheaper regions are still seeing stable, positive price growth.[6]

The owner occupied sector is in a phase of normalisation. Construction activity has been weakening steadily here since 2011. There is almost no growth in building permits for owner occupied apartments, which are rising at 0.4% year on year. Permits for single-family homes even fell 5.0% to reach a new low. As demand for owner occupied property is falling, it can be assumed that the market is seeing a general cooling down.[6]

1.5. Market for rental apartments heading for oversupply

Demand and supply may be moving in step in the owner occupied market, but in the case of rental apartments construction activity is increasingly diverging from demand. The most recent boom in building is undoubtedly a consequence of the pressure on investors to do something with their money. The residential market has been driven by robust immigration over recent years, but this is now waning.[6] The consequences of this trend are already being seen in the rising vacancies in rental apartments, which CS now puts at almost 2% nationally. High vacancies continue to affect mainly the rural regions and communities with significant new construction activity, but residential space is still tight in the metropolitan regions, with a 0.22% vacancy rate in Zurich and 0.51% in Geneva.[6]

[3] Swiss National Bank, Quarterly Bulletin, 3/2016, September 2016
[4] Credit Suisse/Swiss Contractors' Association Construction Cost Index
[5] CS Economic Research, Real Estate Monitor Switzerland, 3rd Quarter 2016, Low Interest Rates Creating Vacancies
[6] UBS Asset Management Outlook for the Swiss Real Estate Market, 2nd Half 2016

Market rents have duly reacted to the varying trends in demand and supply by declining –0.6 % quarter on quarter. (25) This tendency is most perceptible in the new-build segment, at –1.2 %. Regionally, rents in the Zurich and Basel metropolitan areas have been most affected, falling –1.5 % and –1.7 % respectively. (25, 26) Quoted rents are also falling sharply, for the third quarter in a row. (28, 29) At the same time, investor demand for residential property has pushed peak net yields for central locations in Zurich and Geneva to new record lows, at 1.9 % and 2.5 % respectively at present.[7]

The persistently high number of applications for building permits in the rental apartment sector and dwindling immigration indicate that supply and demand will increasingly drift apart, and the sector will have to brace itself for higher vacancies in the residential segment of the investment market.

1.6. Office rents heading down despite modest vacancies

The office market remains tense. Worker immigration remains relatively low. Net immigration hit the lowest level since 2010 in the first half. (12) While the number of job vacancies rose 1.6 % (10) again quarter on quarter, the change in the number of people employed as measured in terms of full-time equivalents fell –0.1 %, so an immediate improvement in the labour market is unlikely.[8] Both the situation in the labour market and structural changes in the modern world of work such as offshoring and desk sharing are resulting in relatively low additional demand for office space. At the moment, it is regions away from the main centres that are most affected by the lack of demand and rising vacancy rates.[9] By contrast, so far there has been no increase in vacancies in the two largest metropolitan regions. In the Zurich region, the amount of vacant

[7] CBRE, Geneva Office Market View, 3rd Quarter 2016; Zurich Market View, 3rd Quarter 2016

[8] BFS

[9] UBS Asset Management Outlook for the Swiss Real Estate Market, 2nd Half 2016

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space fell by 20,000 m², and in Geneva by some 13,000 m². Given the current level of building activity, vacancies are unlikely to stabilise in the long term. In Zurich, around 260,000 m² of new office space is expected by 2021, and as much as 310,000 m² in Geneva.[10]

Apart from the region around Lake Geneva (+0.8 %), office rents are in a clear downtrend. As in the previous quarter, the decline is mainly affecting the Basel and Central Switzerland regions, at –5.1 %. In Zurich the decline in rents was less pronounced at –3.6 %, but still perceptible. (35, 36) In addition, owners are frequently obliged to make other concessions to potential tenants that are not reflected in the rental statistics.[11]

1.7. Non-food a big contributor to lower retail rents

Real estate investors' uncertainty about the retail segment is becoming increasingly noticeable in the market. The sales problems retailers are currently facing are the greatest challenge for the segment. Short-term hopes of a recovery in the first quarter came to nothing as sales fell 1.7 % year on year again in the second quarter. Non-food segments were particularly hit, with sales down by 3.1 %.[11] The weaker retail sales figures are being increasingly clearly reflected in sales-related rents and will result in writedowns on retail stores at year-end. This is due to the familiar story of online retailing and shopping tourism; the poor weather over the summer was an additional dampener for the clothing and leisure sector, where sales fell by 6.7 % and 7.1 % respectively.[11] Retail rents fell 4.7 % nationally between mid-2015 and mid-2016. This situation may get even worse in future, as the digital distribution channel is far from saturated.[12]

The falling need for space in the retail sector raises the question of how the space that is becoming vacant will be used. Doubtless profitable ideas will be found for flexible space in prime locations, but changing use for properties in secondary and tertiary locations in particular will be challenging.

[10] CBRE, Geneva Office Market View, 3rd Quarter 2016; Zurich Market View, 3rd Quarter 2016
[11] UBS Asset Management Outlook for the Swiss Real Estate Market, 2nd Half 2016
[12] Finanz und Wirtschaft, "Now rents are falling in Switzerland", 27.10.2016