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Interpretation of the FPRE real estate meta-analysis Q4/17

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“The positive expectations for 2018 are broad-based”

A pronounced economic upturn is expected for 2018. In particular, the depreciation of the Swiss franc and economic growth in the eurozone give cause for optimism. Since interest rates remain at record lows, construction for future use is continuing. This makes vacancies more likely and puts further pressure on rents across all segments. Despite this trend, the prices of investment properties continue to rise. The favourable economic prospects also provide hope in the retail segment, which has been struggling for a long time.

Swiss economy expected to get off to a buoyant start in 2018

Despite a promising economic setting, Switzerland will not manage an upturn in 2017. Consumer sentiment is exceptionally strong, the economy on the main EU export market remains robust and the overvaluation of the franc has eased. Despite these positive developments, however, a genuine upturn is still awaited. According to the State Secretariat for Economic Affairs (Seco), this is probably primarily attributable to the weak performance of the Swiss domestic market.[1] Because of this starting position the experts have revised their GDP growth forecasts for the year 2017 downwards from 1.5 % to 1.0 % while some institutes (KOF, SECO and UBS) even expect growth below 1 %. (8)

In 2018 Switzerland will continue to benefit from the boost provided by the EU economy and the more favourable exchange-rate setting. The experts are accordingly more optimistic about the future, and many forecasts have been raised further. The forecasts of some institutes are even above the 2 % mark for domestic economic growth in the coming year. (8) Expectations are positive over the long term and are broad-based. In particular, the depreciation of the franc and the strong cyclical momentum outside Switzerland give cause for optimism. According to a survey by Credit Suisse, one additional percent of GDP growth in the eurozone generates a 3 % increase in Swiss exports. In light of this, export growth of 4 % is projected for Switzerland. [2]

Sentiment for 2018 is dampened solely by a decrease in immigration, which in previous years was a steady driver of consumption growth. In all likelihood, net immigration in 2017 will be the lowest it has been in the past ten years. (12, 13) This is due, in particular, to the improved employment situation in the European countries of origin. For 2017 as a whole, net immigration is expected to total only around 50,000, and the migration balance for 2018 is likely to remain at a similar level.[2]

How much longer will the new normal of low interest rates last?

Long-term interest rates are moving sideways at a low level. (20, 21, 22) At the moment, there are no signs that this situation in Switzerland might change suddenly. The ECB’s interest rate policy will not be changed until “well after” the end of quantitative easing[3], so the SNB will have to remain on an expansionary course. With forecasts of 0.1 % to 0.2 % the economic institutes expect returns on government bonds to continue moving sideways along the 0 % limit in 2018. (20) However, European real estate experts do not believe in a lasting phase of low interest rates. According to the most recent study, “Emerging Trends in Real Estate Europe”, more than 70 % of market participants anticipate a slight rise in interest rates over the long term, starting in 2018.[4]

[1] NZZ, Die Schweiz gehört beim Wirtschaftswachstum zu den Schlusslichtern, 5 September 2017
[2] Credit Suisse, Monitor Switzerland, September 2017
[3] Swiss Life Asset Managers, Economic Outlook, November 2017
[4] PwC & ULI, Emerging Trends in Real Estate Europe, November 2017

“There are no signs at the moment indicating a surge in interest rates”

Given the weakening of the Swiss franc against the euro and the associated rise in the price of imported goods, the SNB has adjusted its inflation forecast for 2017 slightly upwards to 0.4% (Q2: 0.3%).[5] This figure is in line with the forecasts issued by experts, which on average continue to project an inflation rate of 0.5% for 2017 and 0.6% for 2018. (8) The modest forecasts are principally attributable to two factors: First of all, residential rents are currently under strong pressure. The lowering of the reference interest rate in June 2017 is viewed as the cause of this, together with a rising supply of rental apartments. Secondly, the healthcare sector is confronted with falling healthcare prices as a consequence of the Swiss Federal Council’s imposition of a reduced tariff structure.[2]

High revenues in the construction sector to continue beyond 2018

The Construction Index as an early indicator of construction activity rose to 146 points in the third quarter. (17) The 7 point increase over the previous quarter corresponds to a rise in seasonally adjusted revenues of 4.8%. This increase was caused principally by the growth of underground engineering (+7.8% quarter on quarter) and commercial construction (+5.2% quarter on quarter) in the course of the third quarter. While residential construction and underground engineering are at a very high level in revenue terms, commercial construction is also recording strong growth. These high revenues are set to continue for the rest of the year and onward through 2018 and 2019. (16) However, as construction activity in residential and commercial construction for future use is continuing, an increase in the number of vacancies becomes more likely. An increase in residential vacancies may lead to price corrections over the medium to long term.[6]

“Construction for future use makes vacancies more likely”

Revenues in building construction are expected to fall over the medium term. In the first half of 2017 building permits declined by 10% over the previous year. This is a first indication that planning and hence the supply of living space is beginning to adjust to demand.[7]

Sharp declines in the price of upscale owner-occupied apartments

The prices of owner-occupied property recorded an increase of 1.8% (quarter on quarter) in the third quarter, thereby almost making good the price drops seen in the first half of the year. This was caused primarily by higher prices for single-family homes (+2.8% quarter on quarter) observed in most Swiss regions. (4, 46, 48) By contrast, the prices of owner-occupied properties moved sideways following the losses recorded in the first two quarters (+0.5% quarter on quarter). Year on year, owner occupied properties have, all told, become a whole 4.5% cheaper. The upscale segment, in particular, has seen a pronounced price drop of 6.0% year on year.[8] (3, 52, 54)

The purchase of private properties for investment purposes constitutes a significant component of the market. Since 2012, the percentage of loan applications for private properties intended for subleasing has ranged between 18% and 20%. The UBS experts see such buy-to-let investments as exacerbating the imbalance in the private property segment and as an economic risk in the event of a cyclical crisis.[9] Thanks to the current positive economic forecasts, however, this risk remains no more than theoretical for the time being.

Capital gains of investment properties expected beyond 2017

The downtrend of residential rents eased slightly in the third quarter and rents rose overall by 0.5%, in response primarily to a 0.9% rise in rents for apartments in older buildings observed in all regions except Jura (-0.5%). By contrast, rents for new buildings remained stable overall in the third quarter (+0.1%). A year on year comparison does, however, show a clearly negative picture with a total decline in rents of 3.3%.10 (25)

“Peak returns on multifamily homes are at a record low of 1.7%”

[5] Swiss National Bank, Quarterly Bulletin, 3/2017 September
[6] Credit Suisse/Swiss Contractors’ Association Construction Cost Index Q3/2017
[7] Swiss Contractors’ Association, Quarterly Statistics II/2017, 6 September 2017
[8] FPRE, Privately-owned property prices in Q3 2017, 11 October 2017
[9] UBS, Swiss Real Estate Bubble Index 3Q-2017, 3 November 2017
[10] FPRE, market rent and building land indexes for investment properties as of 30 September 2017

Although rents are coming under growing pressure (29), demand for investment properties remains high and the price curve continues to climb. This continuing price rise seems surprising especially when compared with privately-owned residential property, whose price trend has calmed down of late. The principal reason for this is the stricter lending policies of banks, which puts a brake on the granting of mortgages to private individuals.[11]

By contrast, the prices of multifamily homes mostly financed with equity capital have risen further and reached peak returns at record lows of up to 1.7%.[12] Looking at the twelve months ahead, most market participants still expect rising prices for multifamily homes (31), while FPRE is assuming that prices will remain stable in 2018.(5) Annual financial statements for 2017 will reflect this situation in the investments in residential properties, which can be expected to again increase in value. UBS estimates them at 1.6% and remains optimistic for the year 2018 with a further rise of 0.3%. This would mean total returns of around 5.5% (2017) and 4.3%.[12]

Employment growth creates hope for the office market

Transaction-based market rents for office space fell by 4.9% in the third quarter and thus remain in free fall. Compared with the previous year the price decline is many times greater with a decrease totalling 12.3%. (34) This price drop has been observed in all regions of Switzerland. (35, 36)

> ***"Falling office space prices can be observed throughout Switzerland"***

By contrast, vacancies are showing a positive performance. The supply percentages for major Swiss cities have declined year on year (Geneva and Zurich). (38) Most market participants still expect the prices of office property to fall over the next twelve months. (41) On the other hand, employment trends give a small amount of hope to the office market. The main one in the second quarter is the rise in situations vacant of 10.5% year on year. (10) On top of this, higher economic growth is expected going forward, which should provide employment with an additional boost. Peak net yields for premium office properties in Zurich currently stand at 2.4% while properties in tertiary locations still have a net initial yield of around 6%. (39) For the upcoming annual financial statements UBS expects the valuations of existing office properties to rise by around 0.5%. The potential for capital gains beyond the year 2017 is likely to have been exhausted, however. By contrast, a more positive trend in the cash flow component is hoped for.[12]

A rethink needs to take place in the retail sector

Revenues in the retail sector rose by 0.7% year on year in the second quarter. This means that growth was recorded for the first time in two years, primarily thanks to the good weather. In particular, the non-food segments of clothing, leisure and DIY benefited. The food segment also recorded marginal revenue growth in the second quarter despite the continuing pressure on prices.[2]

The peak returns on both retail and office properties are 2.4%,[12] but these returns are paid only at central and highly frequented locations in the centres of major cities. All in all, investors in the retail segment became much more risk-averse. As a result, return expectations must compensate for the level of risk assumed. Marketing shopping centres in regions with low purchasing power now entails considerable expenditure. Irrespective of the condition the space is in, finding tenants remains difficult.

[11] NZZ, Riskanter Run auf Mehrfamilienhäuser, 11 September 2017
[12] UBS, Outlook Swiss real estate market H2 2017, October 2017

“The hyper-connected world provides a boost to an unconventional mix of uses”

As the economic prospects have brightened, a more optimistic view of the retail area market has become possible, but the mix of uses has to be right. In the same way as faceless dormitory towns are no longer in demand, old-fashioned, shopping centres that are remote and difficult to reach are becoming less and less popular. In today’s hyper-connected world the blurring of boundaries between private and work life provides opportunities for unconventional mixes of use.[4] The recently inaugurated “Mall of Switzerland” is an attempt to follow this trend. This is Switzerland’s second-largest shopping centre, in which Abu Dhabi’s sovereign wealth fund has invested CHF 450 million, and which is expected to draw up to 15,000 visitors a day. In view of these figures it is not surprising that the retailers in the city of Lucerne have great respect for the new mall. Consumers today cannot be attracted to a shopping centre or city centre with a simple offering of shopping and nothing more, so new solutions are required. It is for that reason that most shopping centres, including the Mall of Switzerland, have for some time been applying the formula, “Fewer products, more experiences”.[13]

Smaller retailers also need a rethink, though, since the “demise of small shops” is threatening in the food segment, in particular. These days, retailers need to create a customer experience if they want to survive. This can be achieved only by creating attractive surroundings and offering competent advice. In the retail trade a trend towards digital, global and mass-oriented suppliers can be observed. At the same time, there is a visible movement towards personal, local and small retailers. In the long term, however, the average shop with a conventional offering and a shop space that doesn’t stand out is set to disappear.[14]

Authors

Kurt Ritz
+41 58 792 14 49
kurt.ritz@ch.pwc.com

Marie Seiler
+41 58 792 56 69
marie.seiler@ch.pwc.com

Samuel Berner
+41 58 792 17 39
samuel.berner@ch.pwc.com

Real Estate Advisory
PwC, Birchstrasse 160
CH-8050 Zurich

[13] NZZ, In der Mall der Zukunft ist Shopping (fast) nebensächlich, 1 November 2017
[14] NZZ, Das neue “Lädelisterben”, 30 May 2017