www.pwc.ch/immospektive

PwC-Immospektive

Interpretation of the FPRE real estate meta analysis Q3/17

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

18 August 2017

Europe is providing increasing impetus to the Swiss economy. For the first time since the cap on the franc-euro exchange rate was lifted in 2015, Swiss companies are rating their situation as positive again. While predicted sales in the construction sector have recently declined somewhat, this development should be of a short-term nature. A normalisation of interest rates is still expected, but at a slower pace than had been assumed in the previous quarter. As expected, the reference interest rate for mortgages fell to a record low of 1.5% in June. This renewed pressure on rents for existing properties is being intensified by falling market rents. Prices in the owner-occupied property sector are expected to continue to fall slightly. The situation in the office market, which has barely benefited from the economic recovery so far, remains difficult. Retail has now been reduced to last position in the general business survey by the Swiss Economic Institute (KOF), although it appears to have finally bottomed out.

"Switzerland's economy is expected to continue its upturn"

Continued recovery of the Swiss economy

Switzerland is currently benefiting from an economically strong Europe. The recent ECB announcement accelerated the appreciation of the euro against the Swiss franc, which in turn is raising hopes for the local economy.[1] Although GDP rose by just 0.3% in the first three months of 2017 compared with the previous quarter, the Swiss economy is in a better state than such a modest result would suggest, based on the rise in investment and exports seen in the same period. The continuing recovery of the export business is very encouraging. It can be traced to the positive economic developments in Europe in particular and is strongly supported by the depreciation of the Swiss franc.[2] Swiss companies rate their situation in July 2017 as largely as good as before the the cap on the franc-euro exchange rate was lifted in 2015. The current upturn is expected to continue in future.[3]

GDP is accordingly expected to continue to grow at an average rate of 1.5%. However, with expected growth of 1.8% for 2018, forecasts have been revised downward slightly compared with the previous quarter (1.9%). (8, 9)

The situation on the labour market has recently improved, albeit slowly, with employment in the first three months of 2017 actually falling on the previous quarter. This is not only slowing consumption, but also impacting the office property market. However, experts at the State Secretariat for Economic Affairs (SECO) predict that employment figures will pick up in future. This positive outlook is also reflected in the job market, where after the first quarter of 2017, the number of vacancies is now 13.7% higher year on year. (10) In addition, the unemployment rate in 2017 is expected to be slightly lower at 3.2% (previous quarter: 3.3%). (8)

Delays in the normalisation of interest rates

On 1 June 2017, the reference interest rate was reduced to a record low of 1.5%. This adjustment comes at an unfavourable time for investors because they are already having to deal with more vacancies, falling market rents and rising refinancing costs.[4] As a result, the underlying mortgage rates also remain at record-low levels. Interest on a 10-year mortgage was 1.6% in May, another 0.1% lower than in February 2017. (23)

The yield curve is generally expected to normalise, although the monthly average value of a 10-year Swiss Confederation bond is currently 0.1%. (21) However, Confederation bonds suffered renewed and pronounced short-term setbacks and posted lower values (-0.17% in June 2017). (22) Although experts continue to anticipate a rise in interest rates, they foresee a lower pace of adjustment than they were predicting in the previous quarter. For 2018, Créa estimates 10-year government bond yields to reach 0.1% (previous quarter: 0.5%). KOF, too, has reduced its yield forecast for 2018, to 0.0% (previous quarter: 0.2%). (20)

1 Swiss Life Asset Managers, Global Economic Scenario, August 2017

2 Credit Suisse, Monitor Switzerland, June 2017

3 NZZ, Konjunktur im Vorwärtsgang (The Economy is Moving Forward), 7 August 2017

4 Schweizer Immobilienbrief (Swiss Real Estate News), 13 June 2017

pwc

“Experts still expect interest rates to rise but at a slower pace”

The SNB is maintaining its inflation forecasts for 2017 at a slightly positive 0.3% for the time being, though it is a little more cautious on the following years, lowering its forecast to 0.3% for 2018 (previous quarter: 0.4%) and 1.0% for 2019 (previous quarter: 1.1%). (11) Economic research institutes are somewhat more optimistic for the short term, predicting inflation of 0.5% for 2017 (previous quarter: 0.4%) and 0.6% for 2018 (previous quarter: 0.6%). (8)

Construction sector remains strong

The CS/SCA construction cost index, an indicator of turnover in the construction sector, cooled slightly in the second quarter, dropping by 4 points compared with the previous quarter. Nevertheless, it remains at a high level of 140 points overall.[5]

The 2.8% decline compared with the previous quarter is mainly due to a 4.2% drop in the civil engineering sector. Experts see this as a normalisation, albeit a temporary one. (17) Especially when it comes to infrastructure, Switzerland has an urgent need for investment in the coming years. For the expansion of the national rail network alone, investments in the range of CHF 18 billion are planned over the next 20 years.[5]

In building construction, revenue also fell slightly, by 1.6% compared with the previous quarter. (17) This is mainly due to the reduction in public building projects and a seasonally adjusted decline in sales of residential properties by 0.8% compared with the previous quarter. Nonetheless, the building construction sector is still expected to perform well in the long term. Despite the more pronounced risk of rising vacancies as a result of intense building activity, investors continue to focus on investment properties. This is unlikely to change much while interest rates remain so low.[5]

“Normalisation in the construction sector likely to be only temporary”

Residential property is and remains cheaper than in the previous year

The owner-occupied property market has significantly cooled off compared with previous years. According to FPRE, prices for residential property (owner-occupied apartments and single-family houses) are currently trending sideways in the second quarter (+0.9% compared with the previous quarter). However, when compared with the same quarter of the previous year, prices have fallen by as much as 4.7%.[6] The SWX IAZI price index also confirms the current sideways movement in the residential property segment with slight growth of 0.7% compared with the previous quarter.[7]

For owner-occupied apartments, prices fell by 0.1% compared with the previous quarter, while the year-on-year decline is more pronounced at 4.1%. The medium-priced segment, meanwhile, reported an increase of 0.7% over the first quarter of 2017. Year-on-year, however, this equates to a decline of 5.6%. (52, 54) Except for southern Switzerland (-3.8%), prices only changed marginally over the quarter (between -0.9% in eastern Switzerland and +1.0% for Lake Geneva). (56) A year-on-year comparison, however, shows that price developments have been far more volatile in different regions. While prices in the main hub regions of Basel (-0.8%) and Zurich (-1.2%) (55) remained relatively stable, those in the other regions declined by between 3.2% (Swiss Plateau) and 8.4% (southern Switzerland).[6]

Single-family houses paint a similar picture. Although prices rose slightly by 1.5% over the last quarter, they have plummeted by 5.2% compared with the previous year. (46, 48) The fall in prices was most pronounced in the Alpine region (-7.9%), in the Lake Geneva region (-6.8%) (50) and in the Swiss Plateau (-5.4%).[6]

The experts surveyed anticipate stable to slightly falling prices in the residential property segment in future. (51, 57) The main factors responsible for this stagnation are probably the high price level and

“The owner-occupied sector reported a significant year-on-year decline in prices of 4.7%”

stricter regulatory measures, while the persisting low-interest rate environment should limit the decline. According to Credit Suisse, the fall in prices will affect owner-occupied apartments more strongly than single-family houses. The main reason for this is a shift in demand for owner-occupied properties from the central areas to more affordable peripheral locations, where single-family houses are far

[5] Credit Suisse/Swiss Contractors‘ Association Construction Cost Index Q2/2017
[6] FPRE, transaction price and building plot indices for owner-occupied property, data as at 12 July 2017
[7] SWX IAZI Real Estate Price Index 2nd Quarter 2017

more prevalent. This cumulative demand will drive up the prices of single-family houses in particular. Another reason for single-family houses' bright future is the greater share of their value that land represents. New land planning legislation has reduced the amount of available land for construction. Combined with the call for higher-density construction, this will lead to a rise in the price of building land.[8]

Residential rents continue to fall

The low reference interest rate is weighing on earnings from property, and market rents no longer promise the same improvement in new rentals as they once did. Rents are falling in all regions compared with both the previous quarter and the previous year. In the second quarter, market rents for rental apartments fell 1.8% overall (old buildings: -1.5%, new buildings: -2.0%) compared with the previous quarter. Much more striking is the comparison with the previous year, marking a drop of 4.7% (old buildings: -3.5%, new buildings: -5.7%). (25) Here the most pronounced fall was 5.2% within one year in the regions Lake Geneva, Basel, Zurich and eastern Switzerland. (25, 26) The surveyed experts anticipate continuing declines in residential rents over the next 12 months. (30)

By contrast, prices for multi-family houses are expected to rise. (31) This imbalance

"Residential rents fell by 4.7% across Switzerland compared with the previous year"

has been observed for quite a while now, and is solely based on investors' lower expectations regarding the rate of return. The continual decline in rents has led to it falling to pre-2014 levels. This trend is expected to continue. UBS expects a total of 50,000 new residential units for the whole of the year 2017 and therefore speculates that market rents will continue to decline.[9] By contrast, investors' interest in residential investment properties remains strong. Only in peripheral areas are investors proceeding much more cautiously than in previous years, which is driving expected returns in these areas up.

The office segment still has very little tailwind

The office space market has not yet managed to benefit from the revitalisation of the Swiss economy. The subdued employment situation in particular is having a negative effect on the leasing of new office space. The current increase in vacant positions in the financial and insurance sector (+16.3% over the previous quarter) (10), together with the positive economic forecasts, however, are giving investors hope that better days are on the way.

Overall, rents for office space continue to decline steeply, falling 5.9% over the previous quarter and plunging 10.9% year on year. This collapse is being felt across all Swiss regions. Most severely affected are office space rentals in the Lake Geneva region, which are down 8.2% on the previous quarter. Compared with the previous year, the Basel region, which has generally shown the least momentum in the past 10 years, reported the largest decline at

"Big difference between rents offered and rental contracts concluded "

13.5%. (34, 35, 36) Investors should not be fooled by the published rents offered. The difference between offered rents and the actual market rents recorded in the finalised contracts has grown markedly since 2016. (34) Offered rents are still tending sideways, held there by the hope that better contracts can be concluded in future. (37)

[8] Credit Suisse, Monitor Switzerland, 2nd Quarter 2017

[9] UBS, Swiss Real Estate Bubble Index 2Q-2017

But owners will have to work hard to make this happen. For some time now the office market has been caught up in a fiercely competitive environment because of overcapacity. This has given tenants greater power and more choice when selecting office premises, which is reflected in their high expectations of office buildings. At the moment, only new builds in prime locations have any chance of being rented out. For this reason, real estate companies are increasingly turning to new buildings as replacements or a total overhaul of their empty properties. It is not only the product, however, that must impress customers but also the service. Rental agreements extending over many years, or delivering buildings as a basic building shell, are no longer in keeping with the times.[10]

Future of the retail sector questionable

Thanks to the mild weather in February and March, the retail sector managed to recover slightly in the first quarter of 2017. The clothing and DIY segments benefited the most, while sales in the food segment stagnated. Although the Swiss economy is in a good state, the situation for the non-food segment remains precarious due to structural changes.[2] While most sectors in Switzerland are recovering, retail is hardly moving at all. Even the hospitality industry, which is always last in the KOF business sector survey, has overtaken retail thanks to the good weather and stronger demand from abroad, and relegated it to last place.

“While most sectors in Switzerland are back on the up, retail has hardly moved”

At least no further price reductions are expected, and the sector should have bottomed out now.[3]

Against the background of such negative developments, is it still possible to earn money with shopping centres? Opinions differ greatly on this point, with the sceptics in the majority and tending to present the more convincing arguments. A much more positive view is held by investors in Switzerland’s second-largest shopping centre, “Mall of Switzerland”, which is to open its doors in early November. Besides the conventional shopping areas, it will also provide recreational and family-centred offers. The mix of retail and alternative uses of floor space is gaining in importance, with the retail portion expected to decline more and more in future. In the non-food segment in particular, businesses are increasingly moving towards becoming showrooms with a smaller share of retail floor-space. Only the future will tell whether the idea proposed by “Mall of Switzerland” – 65% retail, 25% leisure activities and 10% food and drink outlets – will be a success.[11]

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 Zürich

[10] NZZ, Überkapazitäten auf dem Markt für Büroflächen (Overcapacity on the Market for Office Space), 15 July 2016
[11] NZZ, Mall of Switzerland, 19 May 2017