PwC-Immospektive

Interpretation of the FPRE real estate meta-analysis Q1/17

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

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In 2017 the Swiss economy will resume its long-term trend growth and inflation is also likely to rise above zero. Given the current investment climate, the construction industry is confident about the new year. The flip side of this development is the increasing number of vacancies now being seen in apartment buildings, combined with falling rents. Even though transaction-based office market rents project a positive picture, long-term prospects for office properties justify investors' cautious approach. For that reason, investor demand in the office market is mainly focused on high-yielding core properties. Hopes for the retail sector are on the up given the strong burst in 2016, though a great deal of innovation is needed.

Key points in brief:

- *Economic indicators point to positive and broad-based economic growth*
- *In 2017 most industries are likely to have adjusted to the new reality of the strong Swiss franc*
- *Inflation should no longer slip below zero in 2017*
- *The interest rate curve is gradually moving up again*
- *Thanks to a high investment propensity, the construction industry is anticipating a successful year*
- *No major price changes are expected in the owner occupied segment.*
- *The current unabated construction activity is leading to falling rents and increasing vacancies in apartment buildings*
- *The most recent increase in office rents in the fourth quarter of 2016 has not done anything to alter the long-term subdued outlook for the office space market*
- *Hopes are rising in the retail market as a result of year-end business in 2016 and some are focusing on smart, innovative concepts*

1.1. Return to trend growth in 2017

In 2016 many things turned out quite differently from what was expected. The United Kingdom voted for Brexit, the Americans for Donald Trump, and the financial and equity markets went on a rollercoaster ride. While economists were anxious about the year ahead at the start of 2016, the mood seems to have turned positive during the last 12 months. The outlook for 2017 is hopeful. Given expected average GDP growth of 1,6 % (previous quarter 1,4 %) (8, 9), the Swiss economy is likely to already return to trend growth in 2017 (1,4 %-1,7 %)[1]. In addition, the recovery is likely to be more broadly based. While the pharmaceutical and food industries in particular had a positive impact on the economic climate last year, UBS economists expect most industries to have finished making the necessary adjustments to the exchange rate reality and to return to growth in 2017.[1] Economists' positive forecasts continue for 2018, with average growth of 2,0 % (previous quarter 1,6 %). (8, 9)

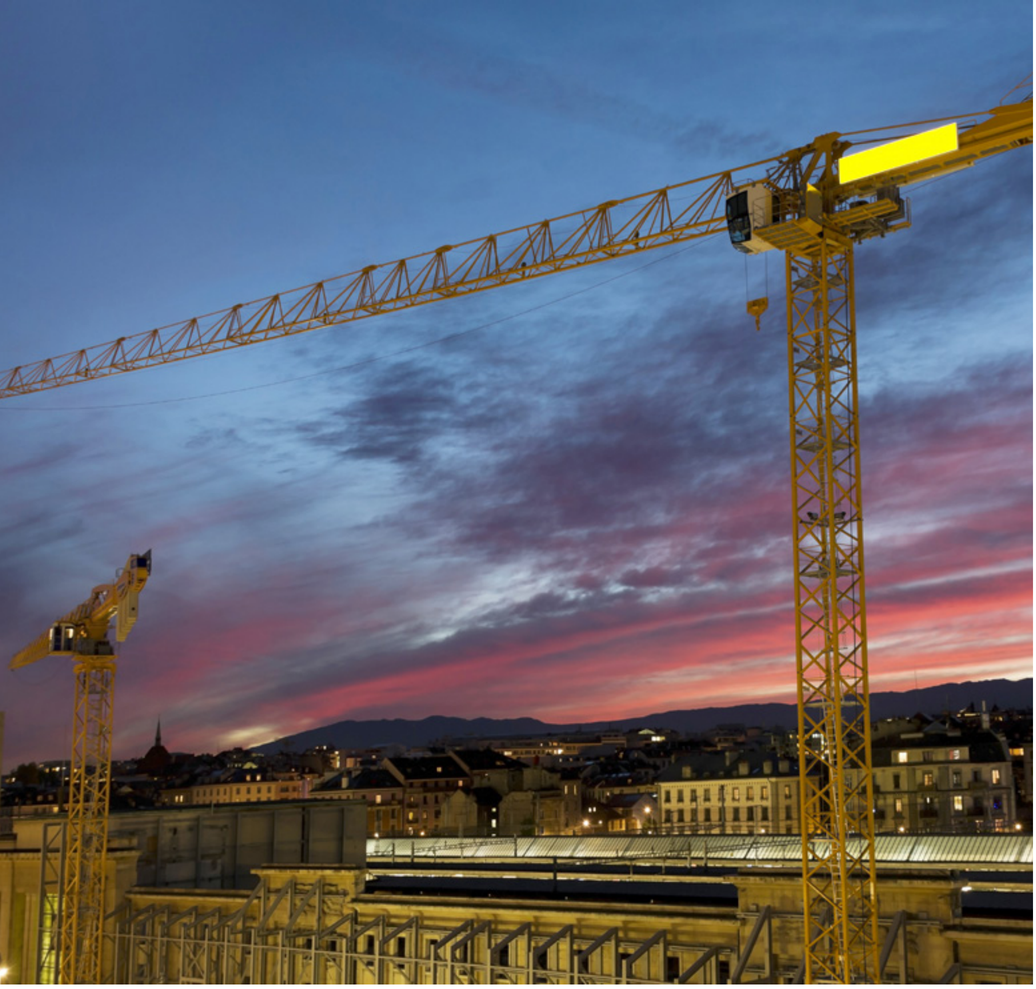
Hopes for more broadly based growth also support the labour market. Projections for the unemployment rate were revised slightly downwards to 3,3 % for this year and 3,1 % for next year. (8, 9, 10) However, there is unlikely to be a tangible recovery in employment growth in the near future – forecasts for 2017 continue to lie below 0,5 %. (10)

1.2. Inflation and interest rates are gradually picking up

In 2017 inflation will no longer be pulled below the zero lower bound by the deflationary effects of the stronger Swiss franc and low oil prices. Nevertheless, economists remain cautious regarding inflation expectations. In December the SNB revised its forecasts for 2017 slightly downwards again, to 0,1 %. (11) The forecast from the economic institutes is – like last quarter – somewhat more optimistic at 0,4 %. Initial projections for 2018 suggest that inflation will continue to see only a moderate increase of 0,5 %. (8)

Interest rates began to rise in the second half of 2016. After the entire yield curve lay in negative territory for a period of time in the middle of last year, it began to move slightly upwards again. (22) Despite this, returns on 10-year Swiss government bonds are still below zero, at -0,1 %. (21)

[1] UBS Outlook Switzerland, The year in scenarios, January 2017



Since the SNB is not expected to increase the key interest rate before mid next year at the earliest[1], projections for 10-year bonds in 2017 remain negative. Confederation bonds may not register positive values, of up to 0,5 % (Créa), until 2018. (20) Mortgage interest rates will follow a similar pattern. After the last increase in 10-year fixed mortgages from 1,5 % in September to 1,7 % in November 2016 (23), the danger of the reference rate being adjusted further downwards in spring has also disappeared.

1.3. Outlook remains positive for the construction industry

The CS/SCA construction cost index[2], which is an early indicator for construction activity, reached the high level of 144 points – supported by civil engineering – in the fourth quarter of 2016. Even though, at -5,2 %, building construction did not achieve the record value of the previous quarter, annual growth was still positive, measuring 5 %. (17) Thanks to the continued high level of applications and permits, the construction industry should continue to be extremely confident about the new year. For example, in November 2016 the 12-month total number of building permits for rental housing increased by 13 %.[3] As a result, experts significantly increased their growth expectations for the construction industry, and in particular for the residential segment (2,0 %) compared with the previous quarter (1,1 %). (16)

However, construction activity will continue to be primarily stimulated by the negative interest rate policy and not by impetus on the demand side. As in the recent past, the supply of living space is likely to grow significantly faster than it can be absorbed. That makes vacancies inevitable. Nevertheless, investors and developers, at least in the residential construction sector, are increasingly responding to the market's changing needs and have recently been focusing much more on small, affordable housing. Given demographic developments, it will be much easier to market these in the near future.

1.4. Prices stabilising in the owner occupied segment

Overall, prices for owner occupied property are trending sideways across Switzerland. According to the FPRE price index, prices for single-family homes fell slightly in the third quarter of 2016; by the end of the year, though, prices increased quarter on quarter, particularly in the low (1,7 %) and medium-priced (1,6 %) segments. (48) Across all segments, prices increased by 1,1 % overall. Compared with the previous year, however, single-family homes are selling for slightly less, registering -0,1 %. (46, 48) Prices for owner occupied apartments across all regions have fallen by significantly more, compared with the previous year, by an average of -2,0 %. Only in the lower-priced segment did prices increase significantly in the last 12 months: by 7,2 %.[4] (52, 54)

According to the latest HEV survey, market participants do not expect any significant price changes in 2017 for single-family homes or owner occupied apartments. (51, 57) The forecasts by Fahrländer Partner and the two large banks CS and UBS point to a sideways movement in transaction and offer prices. (7) A downwards trend should continue to be expected at the top end. (58) Strict regulatory measures in particular, which prevent many households from buying their own home, as well as low levels of immigration, are likely to prevent a rise in demand and therefore in prices.

However, positive price dynamics can be expected in a few regions as a result of local developments in the owner occupied markets. For example, there is still evident appreciation potential in the city of Berne, the municipalities in the Zurich Unterland and the agglomerations around Basel, Lausanne and Lugano.[5]

[2] Credit Suisse/Swiss Contractors' Association Construction Cost Index
[3] CS Economic Research, Real Estate Monitor Switzerland, 4th Quarter 2016
[4] FPRE, transaction prices and building plot indices for owner-occupied property, data as at 31 December 2016
[5] UBS, Real Estate Focus 2017

1.5. Housing market facing falling rents and increasing vacancies

At the end of 2016 market rents for housing fell by 0,5 % compared with the previous quarter. (25) The most recent fall in rents affects both rural areas and the top locations and large, central agglomerations. (25, 27, 28) From a regional perspective, the fall in rents is most strongly felt in the Alpine area and the Jura, with declines of 1,2 % and 1,8 % respectively. (25, 26) Given strong construction activity, rents in the new-build segment are coming under increasing pressure. Compared with the previous year, they fell by 2,1 %.[6] In view of the current trends, forecasts remain negative – the majority of market participants expect rents to fall this year. (30)

The fall in rents is due to an increase in supply and, as a result, more vacancies. Currently, around 2 % of all rental properties in Switzerland are empty. However, the vacancy rate varies depending on segment and region. Properties in bad micro locations and top-end new building projects are particularly likely to have vacancies. However, affordable apartments with efficient layouts as well as older inner-city properties continue to be in strong demand. Given demographic developments, demand for small, age-adapted housing both on the outskirts and in the large cities should rise.[5]

Despite falling returns, prices for residential investment properties are continuing to increase in 2017. FPRE also expects increasing prices in 2017 (5) and market participants shared this opinion in the surveys. (31, 32, 33) In particular, institutional investors such as insurers and pension funds, driven by the scarcity of investment opportunities, remain prepared to accept high prices and thus lower returns. Peak net yields for top locations in the big cities are around 2,6 % on average, marking a new low[5], with returns in Zurich and Geneva lying slightly lower at 2,2 % and 2,4 % compared with 2016, respectively.

[6] FPRE, rental price indices for investment properties, data as at 31 December 2016

1.6. Office segment undergoing structural change

Even if investors often view the office market in Switzerland critically, the sentiment regarding rents and returns appear to remain strong. At the end of the year, transaction-related market rents for office space increased unexpectedly in most regions compared with the previous quarter. (34, 35) The most significant increases were registered in the two metropolitan areas plagued by excess supply: Lake Geneva (5,2 %) and Zurich (2,9 %). Compared with the previous year, office rents remain 2,0 % lower. Around Lake Geneva rents have skyrocketed in the last 12 months, by an average of 8,9 %. By contrast, prime rents in Geneva and partly in Zurich have suffered. Since the peaks of 2011 and 2012, prime rents in Geneva, for example, have fallen by up to 20 %.[5] (35, 36) Quoted rents are largely constant since advertised rents often don't reflect actual market conditions. (37) Overall, rent developments suggest the office market is stabilising.

However, the downside for the office market is office employment. In 2016 office employment registered the slowest growth since the financial crisis, of just 0,2 %; nor is any significant acceleration anticipated for 2017. It is therefore unlikely that the oversupply in the big cities will be reduced. Vacancies for Class B and C properties will increase further as a result. A further challenge for the office market is the increasing optimisation of office space per workplace. In modern open-plan offices, the average amount of space needed for each workspace is now only 12 square metres and the shared desk concept, which is becoming more and more popular, increases the occupancy rate of existing office space. Even without producing new spaces, this optimisation process is transforming the rental market, structurally and for the long term.[5] In addition to weak demand and structural changes, new office projects are continuously being planned. Although the large boom in construction is now over, the 12-month total number of building permits towards the end of last year was 12 % higher than the long-term average.[3] As a result, an increase in supply can be expected in almost all regional sub-markets.[7] The recent increase in market rents is therefore likely to be short-lived and investors' concerns are justified. Investors are reacting to the increasing risks. While demand for core properties in top locations continues to rise and peak net yields stand at 2,4 % on average for Zurich and Geneva[5] and 2,5 % on average for Class A properties, interest in properties in bad locations is modest and returns for Class C office properties remain at 6 %.[8] (39) Investors expect long marketing periods for vacant properties and are looking to avoid properties with risky rental prospects.[7] Long-term price expectations for office and commercial properties thus remain well into negative territory. (41)

[7] JLL, Office Market Report Switzerland 2017
[8] CSL Real Estates, Real Estate Market Report 2017

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1.7. Year-end business raises hopes for retail

With a 1,0 % nominal fall in revenue, last year did not bring any improvements for retail. The food segment continued to be the only support and even this segment could only achieve a negligible increase in revenue of 0,2 %[9]. Finally, in the last few months of 2016, a slight improvement in domestic demand and revenues was observed. It was then that the car trade, in particular, had its strongest months, when seasonally adjusted. Retail was also robust in the last quarter.[10] 2017 should still be viewed with caution. There is still a lack of stronger impetus from the overall economy to support a recovery. Although economic prospects for the coming year are fairly positive overall and Swiss exporters are likely to benefit from a recovery in the global economy, consumer sentiment and purchasing power are likely to improve only gingerly. As a consequence, rents (6) are expected to continue falling for the most part. Demand for retail space will also remain at low levels. Generally, only providers in the food segment are planning to expand.[9]

Investors are rather cautious about planning new sales spaces, but a few new shopping centres will still come onto the market. Given the saturated market environment, there is likely to be an increase in predatory competition. In order to survive, shopping centres need to meet customers' ever increasing demands. New concepts are needed that turn shopping centres into experience centres and "urban market places". In a few exceptional cases, forward-looking providers are responding skilfully to the new situation. For example, the newly opened "Welle 7" in Berne offers, alongside classic retail space, additional attractions in the form of comprehensive services and gastronomy as well as a business centre with co-working spaces.[11]

[9] CS, Retail Outlook 2017
[10] Swiss Life Asset Management, Global Economic Outlook, February 2017
[11] NZZ, "How Migros reinvents the shopping center", 10.01.2017