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Interpretation of the FPRE real estate meta analysis Q2/18
References to FPRE graphics in our text are marked (1) etc.

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The Swiss economy is currently experiencing very dynamic growth. Strong GDP growth of 2.2% is anticipated for 2018. While a recovery can also be observed in the employment market, there is a sole black cloud on the horizon in the form of the weak immigration figures. Meanwhile, the increase in long-term interest rates observed in recent months serves as an increasingly strong indicator of an increase in the general level of interest rates. The positive economic conditions are promising with respect to rents for sales and office space. In the long term, however, a new mindset will be required in both segments in order to reflect the general restructuring of the sector.

"With GDP growth of 2.2%, Switzerland is well above its long-term potential growth"

Swiss economy in the fast lane

The Swiss economy started 2018 with a great deal of confidence. Economic growth in the fourth quarter of 2017 picked up by another 0.7% from what was already a strong preceding quarter. In addition to the general dynamism of the global economy, Switzerland is also benefiting in particular from the ongoing devaluation of the CHF. This has prompted the experts to raise their forecasts for GDP growth in 2018 by an average of 20 basis points, to 2.2%. (8) This means that after three years of below-average growth, the Swiss economy is expected to clearly exceed its long-term potential growth this year and remain in the fast lane with only slightly weaker growth of 1.9% in 2019. (8, 9)

A recovery is still apparent in the employment market. Unemployment has fallen below 3% for the first time since 2012. The accelerated economic growth also means that further improvements in the employment market are to be expected in the future.[1] The expectations for the unemployment rate average 3.0% for 2018 and 2.9% for 2019. (8, 9, 10) The growth in employment also picked up marginally in recent months. Large numbers of jobs were above all created in the financial and insurance services (30.0%) and real estate and residential (26.0%) sectors. The 16.8% year-on-year increase in advertised positions across all sectors in the fourth quarter of 2017 remains above average.[2] (10)

The only dark cloud on the horizon of the encouraging economic climate at present is the low level of immigration, which is taking the wind out of the sails of consumption in particular. The improved situation on the employment markets of EU countries coupled with scaled-down recruitment by Swiss companies led to a historically low rate of growth for the foreign-born population of just under 1%. (14) This means the same as the lowest rate of growth for years. After falling for the fourth year in succession in 2017, net immigration is expected to stabilise at around 50,000 people in 2018.[1] The number of immigrants recorded in the first quarter of 2018 (13,200) was the lowest figure since 2007. (12)

[1] Credit Suisse, Monitor Schweiz, März 2018
[2] SNB, Quartalsheft, 01/2018 März

“Sector preparing for turning point for interest rates”

Turning point for interest rates gets closer

Interest rates in Switzerland have fallen steadily for the last 30 years (with temporary fluctuations). As we know, interest rates have been negative since 2015.[1] But the turning point is getting closer. The market is now expecting general interest rates to rise. A quarter of the institutional real estate investors surveyed by PwC expect interest rates to rise in the short term (1 year). Even three quarters of respondents expect interest rates to rise in the medium term (3 to 5 years).[3] The Fed’s decision to increase the benchmark interest rate by a quarter of a percentage point to a range of 1.5% – 1.75% at the end of March is providing further fuel for the discussion. Two further hikes are even expected in the US in 2018.[4]

While short-term interest rates remain low, an increase in long-term interest rates has been observed in recent months.[1] Between December 2017 and March 2018 the interest rates for 5-year and 10-year mortgages rose by 0.1% (to 1.3%) and 0.1% (to 1.7%) respectively. The interest rates for variable and 3-year mortgages, on the other hand, remain unchanged. (23) The yields from 10-year Swiss government bonds are also above zero once more on a sustainable basis. Most yields have been positive since January 2017. (21, 22) The SNB’s target range for the 3-month LIBOR is still currently -0.25% to -1.25%, which is a comfortable range for the real estate market and does not suggest an abrupt rise in interest rates.[2]

Construction sector to remain strong in 2018

The construction sector seems to have lost some momentum in the first quarter of 2018. The construction index fell by 3 points to 142. This can however mainly be attributed to civil engineering, which lost 5 points in comparison to the preceding quarter. Building construction only saw a minimal reduction of 1 point but remains at a record level of 142 points overall. (17) There are many indications that order backlogs will remain at this high level in 2018. Demand in

“Investment in construction expected to slow down in medium term”

the real estate market is above all being supported by the strong growth of the economy.[5]

Investment in construction is however forecasted to fall in the medium term. Although the order books are still falling in all segments of the construction industry, rising vacancy rates as a result of the overproduction of office and residential space for many years are likely to lead to a downturn in the construction sector.[1] The recent increase in long-term interest rates and the anticipated hike of the base rate are expected to contribute to this slowdown in the construction economy.[5]

Reinvigorated home ownership market

The home ownership market appears to be more robust again following fluctuations in recent quarters. Prices in the first quarter of 2018 remained at a similar level to the preceding quarter. While prices for freehold apartments fell marginally (-0.6% quarter-on-quarter) (3, 52, 54), those for single-occupancy houses rose slightly (+1.6% quarter-on-quarter). (4, 46, 48) A persistent positive trend can be observed in the mid-range segment for both categories. At the start of 2018, prices for freehold apartments and single-occupancy houses rose by 9.0% and 6.3% respectively in comparison to the same quarter of the previous year in the mid-range segment. (47, 48, 53, 54) Only the prices for high-end freehold apartments continued their decline, falling for the sixth time in succession in the first quarter of 2018 (2.4% quarter-on-quarter).[6] (54)

“Continued positive trend in the mid-range owner-occupied property segment”

The owner-occupied property market is almost evenly balanced at present, with supply and demand closely matched. As a result, the vacancy rates for freehold apartments and single-occupancy houses were very low at 0.87% and 0.41% respectively in 2017. The slowdown in the construction industry is expected to lead to a shortage of owner-occupied property

3 PwC, Real Estate Investor Survey H2 2017, März 2018
4 Tagesanzeiger, US-Notenbank hebt Leitzins an, 21.03.2018
5 Baukostenindex der Credit Suisse und des Schweizerischen Baumeisterverbandes, Q1/2018
6 FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 31. März 2018

further down the line. Vacancy rates are therefore expected to remain low in 2018, and Credit Suisse expects the price of home ownership to increase by 2.5% for single-occupancy houses and 2.0% for freehold apartments.[7] Other experts expect home ownership prices to move sideways in 2018. (7)

Residential rental property market caught in supply-side surplus

Generally speaking, there have been more new homes on the market than there is demand in Switzerland for the last 6 years. The most recent official count carried out by the Swiss Federal Statistical Office in June 2017 found around 64,000 vacant homes, which translates into a vacancy rate of 1.45%. The strong pressure to invest on the part of investors, however, is still leading to a high level of investment in construction, and therefore to an ongoing surplus in supply of residential space. More than 51,000 new homes could come onto the market in 2018 alone. The vacancy rate for new properties built within the last two years is just under 10%.[8] Despite these negative long-term trends, market rents for rental properties (rents from contracts) rose again in the first quarter of 2018 after falling a total of 5 times in the last 6 quarters. Market rents rose quarter-on-quarter for both new properties (3.8%) and old ones (2.8%).[9] (1, 25, 26, 27) Experts agree on the whole however that average Swiss rents will fall in 2018. (5)

“Residential rents expected to fall in 2018”

This negative trend is underscored by the rents advertised for apartments. By the start of 2018, advertised rents had fallen by a total of 3.3% since their peak in mid-2015. (1, 28, 29) This was due to rising vacancy rates caused by a supply-side surplus of homes. Advertised rents are expected to fall further in the future, albeit at a reduced rate.[10]

Strong economy as ray of light for office market rents

The office market has not yet been able to benefit from the strength of the economy. The outlook is gradually improving, however. Market rents in the office segment saw further strong declines in the first quarter of 2018, totalling 5.0% in relation to the preceding quarter, which was the fifth negative quarter in succession. In a year-on-year comparison the strongest decline in market rents was observed in the Lake Geneva region (21.5%).[9] (2, 34, 36) Advertised rents were also down at the start of 2018. These provide a less authentic picture of the true state of the market, however, since they do not reflect the incentives offered. (2, 34) Thanks to the strong state of the economy and the anticipated increase in employment, which should support demand, Wüest Partner expects advertised rents to hold steady at this level for the immediate future.[10] The first signs of this are already apparent. According to Wüest Partner the Swiss supply ratio fell by 0.3% quarter-on-quarter to a total of 7.0% in the first quarter of 2018. (38) There are also already some optimistic market participants who expect office rents to rise again. (40)

Office rents fell another 5% in first quarter

In the long term the market for office space will face structural problems stemming from new ways of working and digitisation as well as the transition to a services-based society. Investors also face a risk associated with falling demand for office space.[7] While an average net return

[7] Credit Suisse, Schweizer Immobilienmarkt 2018, Februar 2018
[8] NZZ, Noch mehr Tempo im Mietwohnungsbau – der Druck auf die Mieten nimmt zu, 24.04.2018
[9] FPRE, Marktmieten- und Baulandindizes von Renditeliegenschaften, Datenstand 31. März 2018
[10] Wüest Partner, Immobilienmarkt Schweiz, 2018/1

of 3.23% is demanded for residential property transactions in Switzerland's nine biggest cities, for office buildings the figure is 3.53%. Investors only remain as confident as they are for residential properties when it comes to top-flight properties. The difference between residential properties and office properties in this category is less than 10 basis points in the top 9 cities (2.84% and 2.93% respectively).[3] These long-term prospects have forced investors to change the way they think. One approach that has been discussed a lot recently is converting offices into residential space. Older commercial properties that no longer meet current requirements are re-purposed as residential buildings, provided the zoning allows. A new building is usually sought out, however, because conversion is often very expensive and time-consuming.[11]

Structural transformation for sales space

While the dynamic economic prospects for Switzerland have improved the general situation for retail, this tailwind has yet to have an impact on the leasing of sales space. As an example, according to research carried out by Bilanz, the handbag label Michael Kors paid negative key money amounting to CHF 8.0 million to the Lacoste brand for the latter to assume the handbag label's existing tenancy agreement for the sales area on Bahnhofstrasse in Zurich. It is difficult to judge whether this example is representative of the high street retail market in Swiss cities or whether the conditions of the Michael Kors contract were so poor. One thing that is certain is that just a few years ago, substantial amounts of key money were being paid to the existing tenant for the same sort of deal.[12] Difficulties with leasing are often mainly attributed to the strong growth of online retail. In addition to online trading, however, experts believe that the retailers themselves are also responsible for the downturn. Many of them have failed to adapt to new shopping habits. An analysis of the absolute figures reveals that online retail only accounts for about a tenth of total retail revenue.[13] Other high streets in major European cities also do not seem to be affected as much by this trend.

"Average anticipated net return for top-flight retail properties 3.13%"

Real estate investors do not seem to be so sceptical on the whole. The average anticipated net return for transactions involving top-flight high-street retail properties in the top 9 Swiss cities is 3.13%, and therefore only 20 basis points higher than the average for office buildings. The two biggest cities (Zurich and Geneva) are even on a par with top-flight residential and office buildings with a return of 2.5%.[3] The FPRE survey results are slightly more cautious. Rents are expected to fall on the whole in 2018, which is also reflected by the market values for 2018 and 2019. Only Zurich can expect to see a stable trend for the rents and market values of retail properties this year. (44, 45)

Autoren

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

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

Dan Bihi-Zenou
+41 58 792 98 14
dan.bihi-zenou@ch.pwc.com

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

Real Estate Advisory
PwC
Birchstrasse 160
CH-8050 Zürich

PwC
Avenue Giuseppe Motta 50
CH-1202 Genf

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13 Schweizer Immobilienbrief (259), Detailhandelsimmobilien – Mehr Engagement gefragt, 24.04.2018