www.pwc.ch/immospektive

PwC-Immospektive

Interpretation of the FPRE real estate meta analysis Q3/18
References to FPRE graphics in our text are marked (1) etc.

17 August 2018

Thanks to above-average GDP growth of 0.6% in the first quarter of 2018, the experts have increased their growth forecasts to 2.3% for the rest of the year. In the wake of this economic boom, employment figures have also picked up again, reaching their highest level in ten years. Despite the economic momentum and higher inflation of 1.0% in May 2018, the SNB has kept its interest rate target range at a record low level. The office market has benefited from the economic conditions, recording the first rent price increase in a long time. The retail space market, however, continues to suffer in the face of growing online business. For owner-occupied properties, sharp declines in the high-end price segment have driven down prices, while the prices for residential investment properties continue to rise. However, with lower rental income being recorded, there is heightened risk of a price correction for investment properties.

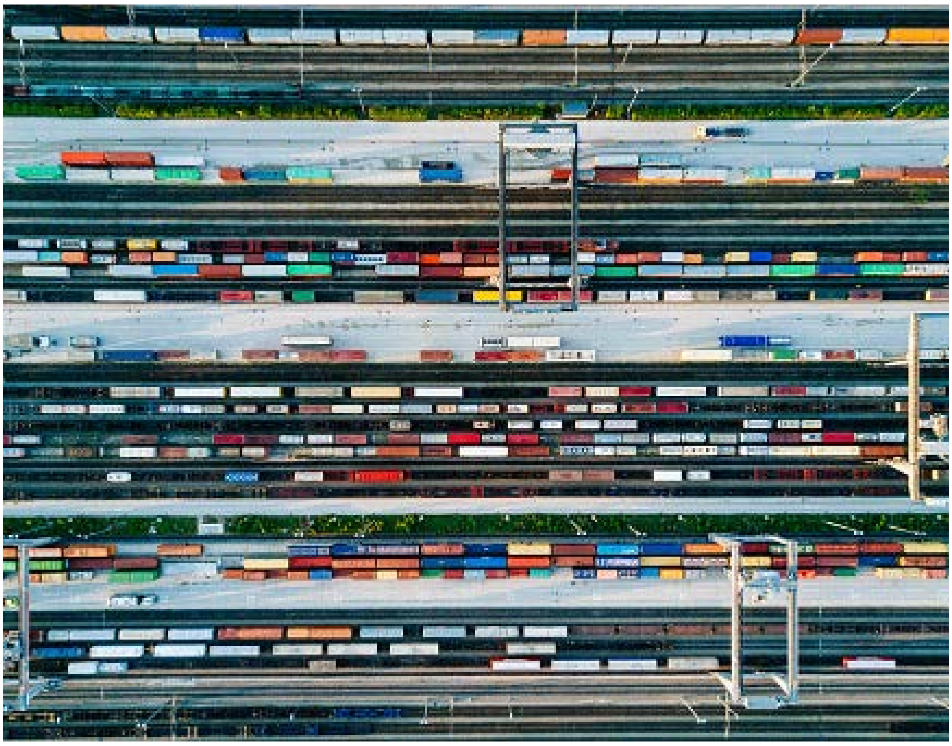
Above-average economic growth

In the first quarter of 2018, the reinvigorated Swiss economy recorded above-average GDP growth of 0.6% in comparison with the previous quarter. The positive result has led to talk of a mini-boom. The experts have also slightly increased their forecasts for 2018, and now assume GDP growth of 2.3% (+0.1% quarter-on-quarter). The economic research institute Créa strikingly increased its expectation by 0.9% in comparison with the previous quarter, up to 2.4%. Overall, the experts' forecasts are a maximum of 20 basis points apart, pointing to generally positive expectations. In 2019, economic growth will likely cool down slightly to a level of 1.9%.[1] (8, 9)

«Highest employment levels since 2008»

The current boom has had positive effects on the labour market. In April 2018, the unemployment rate was at an extraordinary low of 2.7%. (9, 10) In light of the positive signs, the experts have further lowered their forecasts for 2018 and 2019, to 2.8% and 2.6% respectively. (8) In the first quarter of 2018, around five million people were employed, representing the highest level since the 2008 financial crisis. Despite rising employment, there is a labour shortage, especially of skilled labour.[1] This is reflected in the higher number of job vacancies. In comparison with the previous year, the number of job vacancies in the first quarter of 2018 increased by 17.9%. (10)

The second quarter of 2018 saw a slight year-on-year rise in immigration, offsetting the slight decline in the first quarter. Overall, after the first two quarters, net immigration is at a low level similar to that of 2017. (12,13) Since 1 July 2018, implementation of the mass immigration initiative has required employers to inform the RAV (regional employment office) of job vacancies in sectors with an unemployment rate of at least 8%. This gives domestic job seekers a head start. The hospitality and construction sectors, which rely heavily on immigration, have been strongly affected by this.[1]



[1] Credit Suisse, Swiss Monitor, June 2018

Higher inflation forecast for 2018

In May 2018, inflation rose to 1% as measured by the Swiss Consumer Price Index (CPI). This is the highest level recorded since March 2011. This spike was driven by the sharp increase in oil prices, which in May 2018 climbed 15.2% higher overall than in the previous year. In June 2018, the price increase led the SNB to raise its 2018 inflation forecast to 0.9%. However, the impact of oil prices on inflation should lessen from 2019 onwards. The inflation forecast from mid-2019 is instead influenced by subdued expectations in the eurozone. Inflation of 0.9% continues to be the assumption for 2019. The forecast for 2020 was lowered to 1.6% in comparison with March.[2] (8, 11)

«Strong fluctuations in capital market interest rates»

The Swiss National Bank has kept its interest rate target range between –1.25% and –0.25%. The SNB continues to pursue an expansive monetary policy due to the ongoing strength of the Swiss franc. The experts therefore still predict money market interest rates of around –0.75% (interest rate on sight deposits held with the SNB). Only SECO has slightly lowered its forecast for 2019, to –0.6%, in comparison with the previous quarter. (20, 21) Capital market interest rates have shown much stronger movement. The trade conflict between the US and key trading partners, as well as political instability in Italy, have led to rising prices and decreasing returns on government bonds. Returns on ten-year government bonds have even crossed into negative territory at times. In July 2018, they were at 0.0%. The experts have also lowered their return forecasts in this context.[2] (20, 21)

With mortgage interest rates still near their all-time low, the demand for mortgages remains unchecked. In May 2018, mortgage receivables increased by a total of 2.8% in comparison with the previous year. In the second quarter, the interest rate for five-year mortgages showed a quarter-on-quarter decrease of 0.1%, coming in at 1.2%.[2] (23, 24)

Horizontal movement for the construction sector

In the second quarter of 2018, the construction index remained at 142 index points. Building construction recorded another quarter-on-quarter gain, peaking at 123 points. Civil engineering, on the other hand, decreased to 169 points, as the majority of existing orders had already been processed in previous quarters. This normalisation trend should continue in coming quarters. The main growth driver in recent years, residential building, showed a three-point decrease from the previous quarter, coming in at 130 points. This could be an initial sign of slower growth, although this is not suggested by the persistent high volume of existing orders and the high number of building applications at present.[3] (16,17)

«Building construction index benefits from commercial construction»

In the second quarter, building construction primarily benefited from renewed commercial construction, which has reached its highest level in around ten years, at 128 points. The main reason for this is likely the dynamic economic growth in Switzerland.[3] (16, 17)

Sharp price drop in the high-end residential segment

In the second quarter of 2018, high-end owner-occupied properties sold for significantly lower prices, while prices increased slightly in the mid- and low-end segments. The price reduction in the high-end segment had a stronger impact, leading to a 3.2% overall decrease in owner-occupied property prices in comparison with the previous quarter. A quarter-on-quarter decrease in owner-occupied property prices was recorded in all regions of Switzerland, but most noticeably in eastern Switzerland (–3.7%), the Alpine region (–3.9%) and southern Switzerland (–6.7%).[4] (48, 54)

«Stable price development expected for owner-occupied property»

Overall, experts expect that owner-occupied property prices will show stable development in the future. Slight price increases are even anticipated for single-occupancy houses. (7, 51, 57, 58, 60) Affordable financing options and economic momentum continue to spur demand for owner-occupied properties, which remain attractive in contrast to rental properties. A purchase, in comparison with rental, can lead to running-cost savings of 10% to 15%. However, for most potential buyers,

[2] SNB, Quarterly Bulletin, 02/2018 June
[3] Credit Suisse/Swiss Contractors' Association Construction Cost Index, Q2/2018
[4] FPRE, transaction price and building plot indices for owner-occupied property, data as at 30 June 2018

financial sustainability is extremely tight or even exhausted, which considerably reduces the potential of further price increases.[5] Meanwhile, the outstanding mortgage debt-to-income ratio has reached an absolute high.[6] Total mortgage loans are likely to reach CHF 1'000 billions for the first time at the end of 2018. The ratio of outstanding mortgage debt to GDP is currently 146%, which could lead to significant problems if interest rates increase.[7] The development of owner-occupied property prices continues to be curbed by an anticipated increase in mortgage interest rates and heightened competition with vacant rental properties.[5]

Increasing prices for multi-family units despite falling rents

In the second quarter of 2018, residential rents decreased by 1.8% in comparison with the previous quarter, following a surprising slight increase at the start of the year. The same picture emerges whether old or new buildings are considered, with rents having fallen by 2.0% and 1.7% respectively in comparison with the previous quarter.[8] (1, 25, 26) A year-on-year decline of advertised rents of around 3.0% was also observed. (1, 28, 29) Some 160,000 rental apartments were advertised in the first quarter of 2018. This represents an above-average supply figure (rental apartment advertisements in proportion to the total housing stock) of 7.2%.[9] Sluggish population growth may mean that additional apartments are not easily absorbed, putting particular pressure on landlords outside urban centres. Rent reductions have become increasingly necessary to avoid leaving rental properties vacant. The experts therefore forecast further rental price reductions for the current year. (5) However, the economic upswing could come at exactly the right time for the rental apartment market, as better employment forecasts should prop up the continually falling demand.[10]

> ***«Heightened risk of a price correction for investment properties»***

The same picture continues to be observed for the prices of multi-family units. Although residential rents have decreased, the prices for investment properties are rising due to ongoing investment pressure. The experts do not anticipate any changes in this regard for the next 12 months. (30, 31) Sharp price increases are expected in particular for old buildings. (32) Investment property prices have increased by around 60% over the last ten years, while residential rents have increased by only 10% during the same period. Therefore, the strong price increase may not be explained solely as a result of higher rents. The SNB generally assumes that there is a heightened risk of a price correction for investment properties. An interest rate hike could have serious consequences. First of all, this is likely to worsen the default risk for mortgages. If interest rates were to increase to 5%, taking into account 1% each for maintenance and repayments, the rental income would no longer be sufficient to cover the financial burden (interest and amortisation payments) for around 50% of newly concluded mortgages. Second, higher interest rates may reduce the attractiveness of real estate investments in comparison with other asset classes. Considering the high level of construction activity, this could result in a price decline. In this case, banks could in turn demand more capital or other collateral to cover mortgages.[11]

Slight temporary recovery observed in the office market

After five successive quarters of falling office rents, they increased again for the first time in all regions in the second quarter of 2018. In a quarter-on-quarter comparison, rents increased by 2.6% overall. (2, 35, 36)

---

5 UBS, immo news, Summer 2018, issue 2

6 NZZ, "Schweizer Hypothekarmarkt bereitet der SNB Sorge" (Swiss mortgage market worries the SNB), 21 June 2018

7 NZZ, "Hypothekarschulden in der Schweiz erreichen Rekordhoch" (Mortgage debts in Switzerland reach a record high), 7 June 2018

8 FPRE, market rent and building plot indices for investment properties, data as at 30 June 2018

9 Wüest Partner, Property Market Switzerland, 2018/2

«Marketing of offices will remain challenging in the future»

Switzerland's promising economic situation has improved the prospects for the office market slightly and is likely to boost the demand for office space. However, due to the high number of advertised properties, the marketing of offices remains difficult. A total of 7% of all office space is currently on the market.[9] This means that recovery of the office market is likely to be only temporary. Most experts predict falling office rents in the near future. (6, 40, 42)

The Swiss office market has recently recorded strong expansion via international co-working providers. Flexible workspaces with pay-per-use models and business services are now very popular. At present, flexible office concepts are primarily used by startups, freelancers and small companies. These groups benefit from short-term rental contracts and personalised services, and thus from greater flexibility. However, co-working solutions are also becoming more interesting for large companies; the shorter and more flexible rental contracts allow them to adjust their demand for space as needed.[12]

Food segment benefits from the economic momentum

The solid labour market conditions and employment growth have had a positive effect on consumer confidence. However, the retail sector did not show much benefit from this in the first quarter of 2018. Sales moved horizontally overall (+0.1% quarter-on-quarter). Non-food retailers in particular suffered further sales declines of 1.9%. The food segment, on the other hand, recorded growth for the second time in a row (+1.4%).[1]

Structural change triggered by steadily growing online business is shrinking the sales of stationary retailers and thus reducing their demand for retail space.[10] The failure of the Italian fashion retailer OVS in Switzerland serves as an example of the difficult market conditions at present. Less than two years after taking over Charles Vögele, the Italian fashion label OVS relinquished its plans and 140 stores in May 2018 and entered a stay of bankruptcy.[13] In light of the continuing crisis in the market for retail space, the investor response remains cautious. Moreover, no impetus for increased construction activity is anticipated in the near future.[10]

«Difficult market conditions in the non-food segment»

Authors

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

10 Credit Suisse, Real Estate Monitor Switzerland, second quarter of 2018, 24 May 2018
11 NZZ, "Die Nationalbank warnt zu Recht" (The National Bank's warnings are justified), 21 June 2018
12 Immobilien Business, "Mehr Flexibilität gefragt" (Demand for more flexibility), July/August 2018
13 NZZ, "Das italienische Modehaus OVS gibt Charles Vögele und die Schweiz auf" (The Italian fashion retailer OVS relinquishes Charles Vögele and Switzerland), 30 May 2018