PwC-Immospektive

Interpretation of the FPRE real estate meta analysis Q4/18
References to FPRE graphics in our text are marked (1) etc.

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“Further reductions in yields”

The Swiss economy is growing strongly in 2018, thanks to a fortunate conjunction of several factors. However, much of the growth can be put down to individual special factors such as sporting events. The coming year is expected to see growth slow as several drivers lose momentum. This slowdown and the renewed appreciation of the Swiss franc reduce the risk of interest rates rising in the short term. The ongoing pressure to invest is leading to further reductions in yields, especially for multi-family homes. With owner-occupied properties, by contrast, the risk of a real estate bubble has fallen, as prices have only performed modestly recently compared to the trend in the economy. The construction industry cooled slightly in the third quarter, but this is likely to be only temporary. The current economic growth is also leading to a recovery in the office market and rising retail sales.

Business is benefiting from fortunate circumstances

The Swiss economy is growing very rapidly right now. The strongest growth since 2010 can be put down to a fortunate conjunction of several factors. Apart from positive global economic growth, low interest rates and a weaker Swiss franc, 25 % of growth over the last six months was attributable to sporting events such as the Winter Olympics and the Football World Cup.[1] The experts have moved up their forecasts for economic growth for 2018 accordingly, to 2.8 % (+0.5 % quarter-on-quarter). (8, 9)

“The party will end in 2019”

The party is likely to be over in 2019, though, as several growth drivers are weakening. The global upturn is losing momentum and net immigration continues to be low, which has a negative impact on domestic consumption.[2] Lower expected investment and falling demand for exports are a further dampener, so all in all there will be less of a following wind for the economy in 2019. The experts' growth forecasts for 2019 are 1.8 % (-0.1 % quarter-on-quarter), which is closer to long-term potential growth for Switzerland again.[1] (8, 9)

Immigration remains low. 2018, like the previous year, is expected to see net immigration of around 50,000 people. This means that for the first time since 2014 there will be no major decline, although the historic low seen in 2017 will likely be beaten again on the downside.[1] (12, 13)

The labour market has improved thanks to the strong economy and low immigration. The number of vacancies in the property and residential industry and IT services has developed particularly positively. (10) The experts have cut their unemployment forecasts for 2018 to 2.7 % (-0.1 % quarter-on-quarter). Employment is likely to grow further in 2019. The overall assumption for unemployment in 2019 is 2.5 % (-0.1 % quarter-on-quarter). (8, 9)

Interest rates expected to rise in the medium term

Even though domestic inflation is rising slightly, the Swiss National Bank (SNB) continues to anticipate a rate of 0.9 % for 2018. Owing to the stronger franc, though,

[1] Credit Suisse, Monitor Switzerland, September 2018
[2] Swiss Life Asset Managers, Perspectives, Economy, November 2018

the SNB has cut its inflation forecast for 2019 to 0.8 % (-0.1 % quarter-on-quarter) and for 2020 to 1.2 % (-0.4 % quarter-on-quarter). (11) The SNB continues to try to stabilise inflation at a positive level and support the economy with a persistently loose monetary policy. The sustained strategy of negative interest rates is stemming the upward pressure on the franc. Nevertheless, the currency has appreciated perceptibly since the summer, reducing the danger of a turnaround in interest rates in the short term.[3]

> “Little danger of a turnaround in interest rates in the short term”

International risks like the simmering crisis in Turkey and the potential trade war between the USA and China had no impact on interest rates. The target band for three-month LIBOR remains between -0.25 % and -1.25 %.[3] (20, 21) Consequently, yields on government bonds remained stable at a low level in the third quarter. The yield on a ten-year Swiss government bond remained stubbornly around zero. SECO and KOF have lowered their forecasts for the ten-year government bond yield in 2019 to 0.3 % and 0.2 % respectively. (20, 21, 22)

Three quarters of investors polled in the PwC Real Estate Investor Survey expect interest rates to rise over the next three to five years.[4] Switzerland is generally heavily affected by the level of European interest rates, and unlike the Fed, the ECB has so far done everything to keep rates low. However, the positive trend in the Swiss economy in 2018 increases the pressure on the Swiss National Bank and its policy of negative interest rates.[5]

Slight cooling in construction

The construction index fell three points quarter-on-quarter in the third quarter to 138, the lowest level for two years. The decline is mainly due to building construction, which fell six points quarter-on-quarter, while civil engineering held steady. Residential construction dropped six index points quarter-on-quarter, unable to maintain the high level it has been at for the past two years. (17) The overhang of supply in rental apartments is causing some investors to hold off, which is reflected in declining orders in residential construction.[6]

The slight cooling off in construction activity was to be expected and should only be temporary. The combination of economic growth and low interest rates creates a climate that encourages investments and supports the building industry. This can be seen in the consistently high number of planning applications. The general turnaround towards overproduction in the construction industry is only expected in the medium term if interest rates rise. For the current year the experts are expecting a rise of 1.1 % in construction, with slight falls of 0.9 % and 0.1 % in 2019 and 2020.[6] (16)

> “Correction was expected and should only be temporary”

Prices rise for owner-occupied properties

Owner-occupied properties rose in price in the third quarter. In the lower-price segment owner-occupied apartments and single-family homes were up 2.4 % and 3.6 % quarter-on-quarter respectively. The higher-price segment also stabilised after declines in recent quarters. The price of high-end owner-occupied apartments rose 2.1 % quarter-on-quarter, the first increase after seven quarters of decline, and single-family homes also went up 2.9 % quarter-on-quarter. Overall, owner-occupied properties saw a rise of 2.3 % quarter-on-quarter. This increase was felt across all regions, although prices for owner-occupied properties rose most strongly in southern Switzerland, at 3.9 % quarter-on-quarter.[7] (48, 54)

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[3] SNB, Quarterly Bulletin, 03/2018 September
[4] PwC Real Estate Investor Survey, Volume 8, H1 2018, October 2018
[5] Credit Suisse, Real Estate Monitor Switzerland, September 2018
[6] Credit Suisse/Swiss Contractors’ Association Construction Cost Index, Q3/2018
[7] FPRE, transaction price and building plot indices for owner-occupied property, data as at 30 September 2018
[8] Swiss Real Estate Institute, Online Home Market Analysis (OHMA), 26 September 2018

“The risk of a real estate bubble is falling, even though prices are higher”

Owner-occupied apartments in particular have seen increased demand recently. A study by HWZ indicated that despite increased supply of owner-occupied apartments, the average advertising period has fallen 32 % to 70 days in total. Along with the fact that many owner-occupied apartments are bought for investment reasons, the increase in the price of single-family homes means that households are increasingly demanding owner-occupied apartments.[8]

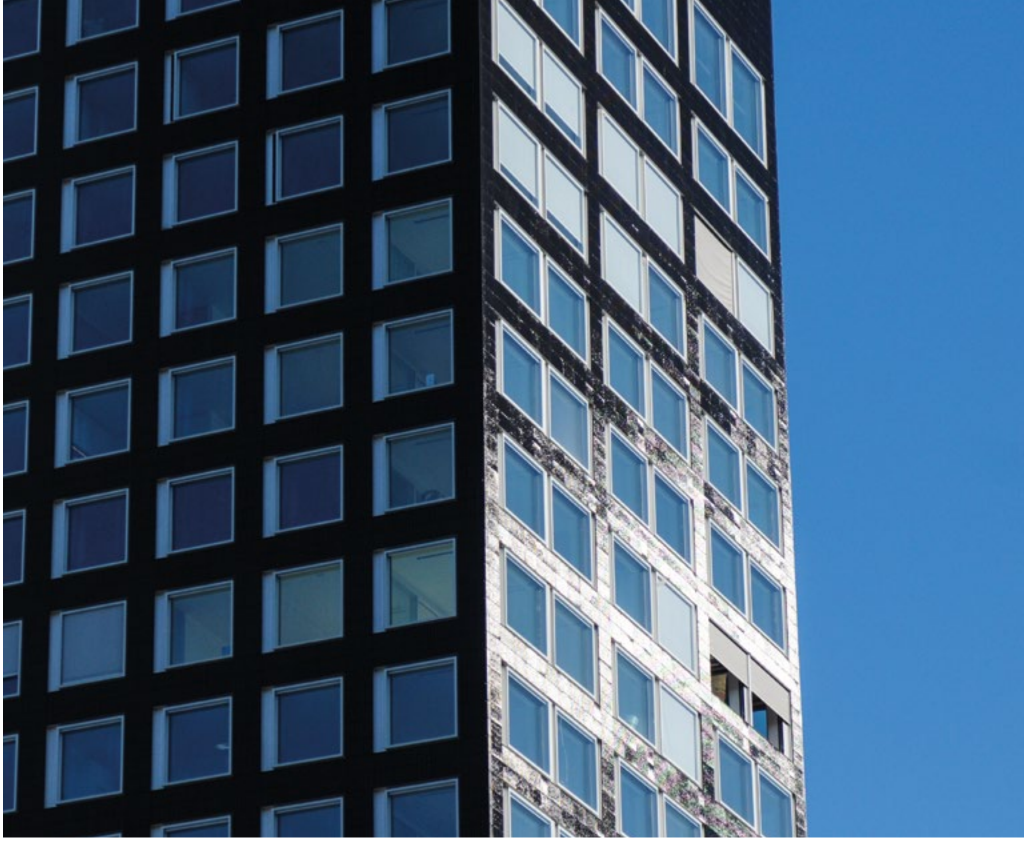
We continue to expect prices to remain stable in the future. (7) A strong economy, falling unemployment and low financing costs are supporting demand for owner-occupied properties. On top of that, fewer projects are coming to market, reducing supply and hence supporting prices.[4]

Although the price of owner-occupied properties rose in the third quarter, the UBS Bubble Index fell to 0.87, putting it outside the danger zone for the first time since 2012. Despite economic growth and low interest rates, the price of owner-occupied properties has risen by only 0.8 % annually since 2015; as a consequence, the indications of a real estate bubble in owner-occupied real estate have diminished.[9]

Persistently high vacancies in rental apartments

The fall in immigration in recent years and simultaneous brisk construction activity has resulted in overproduction of apartments, and supply has moved out of line with demand. Compared to the 2007 average, the number of apartments approved in agglomerations and other municipalities is up by around two thirds. In the centre, by contrast, the rise was just a third.[5]

The Swiss Federal Statistical Office counted around 72,000 apartments vacant in 2018. This gives a vacancy rate of 1.62 %, a rise of just under 13 % on 2017.[10] This sharp increase is mainly a consequence of the overproduction of rental apartments mentioned above. About 80 % of properties currently unoccupied are rental apartments, giving a vacancy rate of 2.51 % for the sector. Vacancy



“Net yields fell by 25bp over the last six months”

rates vary considerably by region. Regions far from the centre and agglomeration regions of small and mid-sized centres are by far the most affected by vacant apartments.[5] Hence the more peripheral regions of eastern Switzerland (2.08 %) and Ticino (2.02 %) have the highest vacancy rates.[10] Major centres, where demand continues to exceed supply, are less affected. The cities of Zurich and Bern even have slightly lower vacancy figures.[4] The Zurich region has the lowest vacancy ratio overall (0.99 %).[10]

Market rents for apartments moved sideways overall in the third quarter (+0.3 % quarter-on-quarter). While rents for older buildings rose 0.9 % quarter-on-quarter, newly constructed buildings saw a marginal fall of 0.2 % quarter-on-quarter.[11] (1, 25)

Given the persistently low interest rate environment, real estate remains attractive for investors despite higher vacancies. High demand is putting pressure on yields on properties in central locations.[5] The PwC Real Estate Investor Survey shows that net yields on prime properties fell again in all major cities apart from Lucerne. Zurich continues to lead with a net yield of 2.2 % on prime properties, closely followed by Geneva at 2.3 %. In the middle of the field are Basel, Bern, Winterthur, Lausanne and Lugano on net yields of 2.6 %. Over the last six months net yields on prime properties have tumbled by an average of 25 basis points in total.[4] This strong compression, along with a lack of available land in central locations, has forced investors to look at agglomerations and rural areas.[5]

Office segment continues to recover

Market rents for offices recovered further in the third quarter. They rose 3.1 % quarter-on-quarter, an upward trend for the second quarter in a row.[11] (2, 35, 37) This should not distract from the fact, however, that rents are still at an all-time record low level.[10]

“Demand for office space up due to economic growth”

In many cantons the amount of vacant office space has stabilised or even fallen. Rising demand has mainly been driven by the economy and the improved labour market. Employment growth in the services sector and IT in particular have resulted in a greater demand for space.

[9] UBS, Swiss Real Estate Bubble Index, Q3/2018
[10] NZZ, The number of vacant apartments is up sharply, 12 September 2018
[11] FPRE, market rent and building plot indices for investment properties, data as at 30 September 2018

In Geneva the situation is more nuanced. Empty office space has risen 44 % due to steadily increasing supply. Total construction permits for the last 12 months in the canton of Geneva are around 25 % above the Swiss average.[5]

Persistently low interest rates mean that the office market remains attractive for investors.5 The PwC Real Estate Investor Survey has shown that net yields in Zurich, Basel, Bern, Lausanne and Winterthur have declined once again. Zurich remains in top position with a net yield of 2.4 % on prime properties.[4]

7. Retail sales growth

Retailers saw sales growth of 2 % year-on-year in the second quarter. Food was up 2.9 % year-on-year, non-food 0.6 %. Apart from the good weather, the growth is mainly ascribed to special effects such as major sporting events. The retail sector can therefore expect to see a slowdown in future.[1]

Sales in stationary non-food rose by a total of CHF 0.9 billion in 2017, with growth of CHF 0.8 billion in online sales. This demonstrates that structural change and its negative impact on the demand for retail space is continuing. Overall, offered rents for retail space fell 0.3 % year-on-year in the second quarter, putting them 10 % below the last peak seen in 2012. In this environment factors like building concept, quality of location and flexibility of space take on increased importance.[12]

> “Structural change continues”

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[12] UBS, Swiss Real Estate Outlook, Edition 2H18