PwC-Immospektive

Interpretation of the FPRE real estate meta-analysis for Q2/20
References to FPRE graphics in our text are marked with “[1]” etc.

Unusually high uncertainty surrounding economic development

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Forecasts are particularly fraught with uncertainty during the COVID-19 crisis. A deep recession is unavoidable, but once lockdown is over we may still see a fast recovery. There is a downward trend in the level of employment growth and immigration. Domestic consumption has collapsed, at least temporarily. Despite a slight increase in financing costs, the residential real estate market is a safe haven for investors and is proving to be robust during the crisis. There has been little direct impact on office real estate in the short term, although rents in this segment had already dipped prior to COVID-19, and the forecasts are looking gloomier. The long-troubled retail spaces are under even greater pressure due to lockdown and the acceleration in digital transformation.

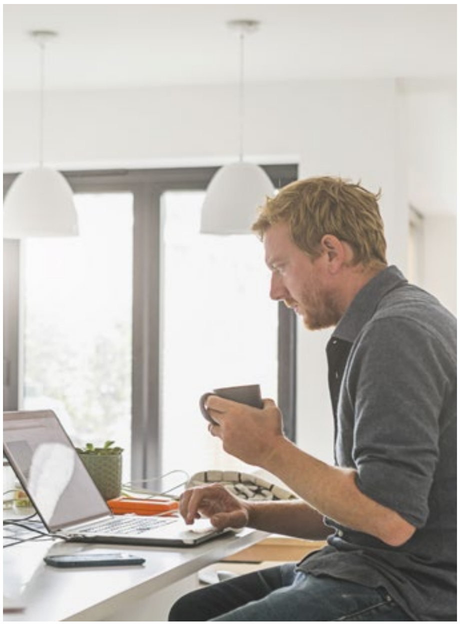
Deep recession cannot be avoided, at least not in the short term

The COVID-19 pandemic unexpectedly put the brakes on the global economy. Switzerland is also suffering from supply and demand shocks, which will trigger a deep recession.[1,2] Experts have lowered Switzerland’s GDP outlook for 2020 considerably (UBS to -4.5%; SECO to -6.7%) compared with the previous quarter. In Q1, economists still predicted positive average growth of 1.4% [8]. Forecasts are extremely cautious, as there is unusually high uncertainty about how the situation will evolve.[3,4] More recent forecasts are also mostly lower than previous ones. The State Secretariat for Economic Affairs (SECO), for instance, revised its forecast from March (-1.5%) to -6.7% on 23 April and is even expecting one of the biggest slumps in GDP for decades.[5] How severe the recession will actually be depends on how quickly the economy recovers. As the cause of the crisis is exogenous, it may experience an immediate recovery once the restrictive measures have been completely lifted. In 2021, experts are predicting an economic catch-up effect, provided that the situation eases in the second half of the year.[3,4,6] The GDP forecast for 2021 has increased to 3.4% (previous quarter 1.5%) [8] and is thus above the long-term potential growth level of 1.6% to 1.8%. [9]

The major uncertainty is hampering overseas demand for goods, which is being felt directly by the Swiss export industry. The pharmaceutical sector will likely prop up the trade in goods, as it reacts with less sensitivity to economic fluctuations. The level of uncertainty is forcing many companies to delay or even cancel investments. Restricted business activity is leading to a decline in imports and in employment.[4,6] And lower demand for workers will at times reduce immigration levels in the medium term [12,13,14].[7] Although a rapid rise in unemployment has been temporarily prevented through short-time work, it will increase considerably further down the line. Expected unemployment for the current year is 3.2% (2.4% in Q1/20), with a stable rise expected in 2021 (3.3%, Q1/20: 2.6%) [8]. During lockdown, domestic consumption has experienced a temporary dramatic decline and with the reopening of the economy will make only a hesitant recovery.[5] Private consumption as well as the healthy employment market had been supporting the domestic economy for a long time and will slow down as a result of COVID-19.[1,4]

Negative inflation prospects and higher interest rates

In order to stabilise the situation, the SNB has stepped up its intervention on the foreign exchange market and reduced the negative interest charge for Swiss banks by increasing the threshold.[3] Adjustments to the SNB reference rate, which is still at -0.75%, are not expected over the course of this year.[8]



1 Zürcher Kantonalbank (ZKB), Anlagen International 5/2020
2 UBS, Outlook Schweiz/2. Quartal 2020
3 Schweizerische Nationalbank (SNB), Quartalsheft 1/2020 März
4 Credit Suisse (CS), Monitor Schweiz/1.Q 2020
5 SECO, Medienmitteilung vom 23. April 2020: Stärkster Rückgang des BIP seit Jahrzehnten erwartet
6 SECO, Konjunkturtendenzen/Frühjahr 2020
7 ZKB, Immobilien aktuell/Ausgabe April 2020
8 UBS, Newsletter vom 23. März 2020: Wirtschaft Schweiz

Forecast for a huge drop in revenue from Q1

Late deliveries of materials and an abrupt halt to immigration have also led to delays in construction investments.[7]

For the first quarter of the year, the outlook for revenue fell by 6.3% overall compared with the previous quarter, and is roughly on par with the previous year's level (-0.7% compared to the previous year, 142 points) [17]. As was already the case at the end of 2019, building construction is responsible for the decline (-8.2% compared to previous quarter). Major office projects like "The Circle" in Zurich have curbed the decline in revenue for commercial construction (-13.3% compared with previous quarter) over several years, which is now coming to an end with the upcoming completion. Revenues in the civil engineering industry are slightly more volatile and also dipped by 4.4% in Q1/20. This is expected to be a brief decline though, as there is sufficient work lined up in the public sector.[10]

The owner-occupied housing market is taking a break

Transactions concluded the end of the first quarter had not yet felt the effects of COVID-19. The impact will first be reflected in the figures at the end of the next quarter.[11] During the first quarter, prices of owner-occupied property kept up the momentum of the previous quarter and rose by 2.5% across Switzerland (+4.9% compared with the previous year). Both owner-occupied housing (OOH [3,61,62]) and single-family homes (SFH [4,55,56]) reported price gains, mainly in the upper price segment (OOH +3.7%, SFH +3.3% compared with Q4/19).[12]

In today's environment, both buyers and sellers are adopting a wait-and-see strategy for the time being. Besides the difficulties involved in visiting properties and moving house, interested buyers are uncertain of what the exact impact of the crisis will be. The same is true for sellers, who are not yet ready to drop their prices, as nobody knows how long the slowdown will last. In the favourable financing environment, owning a property is still an attractive option.[7,14] With interest rates even lower, it is also assumed that demand will quickly pick up again.[11] Nevertheless, holiday homes – a typical luxury

Interest on Swiss government bonds and financing costs rise by more than 20 base points

Uncertainties on the international markets are leading to a rush to stable currencies like the Swiss franc. The upward pressure is making imported goods less expensive. What's more, the price of oil has fallen significantly and, due to the recent drop in the reference interest rate, prices for rental accommodation are expected to decline.[4] The inflation forecast for 2020 has decreased from 0.2% in February and has now entered negative territory at -0.5% [8]. Business is expected to return to normal within a year, with positive inflation of 0.2% set to return in 2021 (0.4% in Q1/20) [8].

Following the COVID-19 outbreak, the yield from 10-year Swiss government bonds initially rose at the start of April (-0.25%) and has since fallen gradually to a lower level (-0.52% at the start of May).[9] The yield forecasts are between -0.5 and -1.0% for 2020 and between -0.3 and -0.9% for 2021 [20,22]. The interest rates on Swiss 3-year and 10-year mortgages reacted the same way to the COVID-19 pandemic. From February to March, they rose by 10 and 20 base points to 1.1% and 1.4%, respectively, suggesting an increase in financing costs due to the current uncertainty [23].

Civil engineering underpinning the construction sector

The decrease in the number of building permits, in particular for commercial and residential buildings, has been pointing towards a decline in construction activity for some time. Due to the COVID-19 crisis and the impact on liquidity management, many companies have also been forced to delay or cancel planned investments.[4]

[9] SNB, Online: Aktuelle Zinssätze und Devisenkurse, Datenstand vom 4.5.2020
[10] CS, Bauindex Schweiz/1. Quartal 2020
[11] ZKB, Immobilienbarometer/1. Quartal 2020
[12] FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 30. März 2020
[13] Immobilienbrief, Ausgabe 298/21. April 2020
[14] Credit Suisse, Medienmitteilung vom 1. April 2020: Corona zwingt den Schweizer Immobilienmarkt nicht in die Knie

Owner-occupied property market stalls after 2.5% price rise in the first quarter

– and homes in the high-price segment are more susceptible to crises than private homes in the lower price categories.[15] For the time being, the number of transactions will likely fall, while prices will take a slight hit in the short term but remain stable overall.[14,16]

Residential rents to feel impact of a noticeable dip in demand in Q2

Shortly before the COVID-19 outbreak (Q1/20), residential rents (transaction rents) enjoyed unusually positive growth compared to the previous weaker quarters [25]. They rose by 1.6% throughout Switzerland, reaching the previous year's level (+0.4%). By regional comparison, the biggest rise of 3.7% for market rents compared with December was in southern Switzerland, which was otherwise faced with dampened prospects. On the other hand, they fell by 1.7% in the area of Zurich and 1.4% in Geneva, for example. The Alpine region only saw a slight decline in rents (-0.8% compared with Q4/19, -0.5 compared with the previous year) [26].[17]

We'll have to wait until the next quarter to see how the figures develop during and after lockdown. In contrast to residential property, declining job security and dwindling immigration [12,13] might lead to a noticeable decline in demand for rental accommodation.[14] The fall in new build activity will more or less stabilise, but the supply will remain high due to the heavy investments made in new builds over the last few years.[16,18] Thanks to measures introduced by the state, like short-time work, a tsunami of rent defaults is not expected.[19] Vacancies are likely to increase further at a low level, in turn putting advertised rents under pressure again [28,29]. In the meantime, the recently lowered reference interest is resulting in a decrease in current rents.[7]

The slightly expensive financing costs have so far had no impact on the observed yield requirements in the residential sector. The stable residential property market in Switzerland still appears attractive to investors, in some instances because of the significantly lower vacancy risk compared with properties for commercial use. In May, the estimated real discount rate of 2.00% for medium-sized residential property in like-new condition at a prime location in Zurich was below the previous year's level (2.03%) [34]. The cities of Geneva (2.3%) and Lausanne (2.6%) also saw initial net yields drop by 10 base points compared with October 2019. Throughout Switzerland, the minimum yields in the cities fell by just 2 base points, while maximum yields saw a drop of almost 20 base points.[20] In the next two quarters, we expect to see a sideways trend for yields in urban centres and agglomerations. But the aversion to peripheral locations that was already observed in 2019 is likely to be reflected in slightly higher yield requirements.

Sideward trend expected following another downturn in yields

Fall in demand for office spaces not just due to COVID-19

In the first quarter of 2020, market rents (transaction rents) for office space decreased by 1.2% for the first time since the start of 2018, continuing to sit around 5.5% above the previous year's level [2,35,37]. Rents declined in the regions of Zurich (-2.1%) and Central Switzerland (-0.6%), but by annual comparison were above average (+6% and +8.8% compared with the previous year). Rent prices in the Basel region are robust, with a 1.9% increase in the last quarter and a 10.9% jump compared with the previous year's level [36]. In the canton of Basel-Stadt alone, the increase even reached 16.5%, making it the top-performing canton for the third quarter in a row. In the canton of Zug, the compression of rent prices stopped at the start of the year for the first time since the beginning of 2016 (+0.4% compared with Q4/19), but it is still the

Office space rents fell by 1.2% in Q1 prior to COVID-19

only canton with a negative annual trend for several quarters in succession.[17]

It is difficult to measure the effects of COVID-19 on the basis of the data from 30 March. Essentially, offices and service companies are feeling the impact less than commercial tenants, but many of them will experience a slump in revenue due to fewer orders. Only a few companies are using the crisis to come up with new business ideas, rethink their business model and become more resistant.[21] COVID-19 has led to less demand for office space in two ways. Firstly, the uncertainty is reflected in the halt to floor space expansion. Secondly, companies were forced to invest in IT to set up a fully functioning home office system.[7,19] Around a third of the workforce in Switzerland worked from home full time in April, with another 20% working at home part time.[22] Now this new way of working has been set up, the trend will become increasingly established and offer potential savings. What's more, the uncertainty will result in increased demand for shorter and more flexible rental contracts. Meanwhile, a slight increase in the supply of small spaces is expected in the near future. Despite aid from the state, an above-average number of small businesses will likely close down.[7,19]

The yields from city office properties in prime locations across Switzerland fell sharply in Q1/20 (pre-COVID-19) compared with October 2019. In St. Gallen (2.8%) and Winterthur (2.5%), levels fell below 3% for the first time. Yields in Lausanne (2.3%) were once again on par with Geneva (2.3%). In addition, experts are seeing the lowest yields in Zurich (2.2%).[20] As was already the case before COVID-19, office properties in central locations (front office locations) will be exposed to less vacancy risk and will remain resilient during the crisis. Back office locations will come under even more pressure faster than expected due to the latest developments. The yield requirements in this segment are likely to rise accordingly over the next two quarters.

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15 Neue Zürcher Zeitung (NZZ), Medienmitteilung vom 12. April 2020: Schockstarre beim Wohneigentum

16 Wüest Partner Immobilienmarkt Schweiz 2020/2

17 FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 30. März 2020

18 Credit Suisse, Schweizer Immobilienmarkt 2020/März 2020

19 JLL, Newsletter vom 20. März 2020: Auswirkungen von COVID-19 auf den Schweizer Immobilienmarkt

20 PwC, Real Estate Investor Survey, Volume 11/März 2020

21 PwC, strategy&: COVID-19: UK industry focus

22 NZZ, Medienmitteilung vom 29. April 2020: Corona und Home-Office: Rechte und Pflichten der Arbeitnehmer

Estimation real estate Switzerland

Resilience	Positive to neutral impact of COVID-19	Slightly negative impact of COVID-19	Very negative impact of COVID-19
High	▪ Social housing ▪ Affordable housing	▪ Healthcare ▪ Industrial/warehouse	▪ High street shops ▪ City centre shopping centres
Medium	▪ Private rented residential ▪ Data centres	▪ Central city offices ▪ Parking ▪ Student housing	▪ Retail parks ▪ Shopping centres ▪ Peripheral offices
Low	▪ Retirement/assisted living ▪ Logistics facilities	▪ Serviced apartments ▪ Business apartments	▪ Hotels ▪ Leisure

Less interest in retail properties

Existing conversion strategies for retail spaces gaining in importance

Retail and catering are some of the sectors most severely impacted by the COVID-19 crisis.[7] Small businesses with high fixed costs and those that rely on passing trade or tourism will feel the effects in the longer term. Continued restrictions on international travel as well as caution among domestic consumers will probably continue to preoccupy the retail sector even once the lockdown measures have been lifted.[19] Although support has been offered by the state to prevent mass rent defaults, shortfalls in liquidity are resulting in many requests for rental concessions. From the owner's point of view, a certain amount of flexibility and even a temporary rent waiver is probably the best option compared with finding new tenants, especially in peripheral locations.[7] Given the unclear legal situation and political interventions in existing rental agreement obligations, it is not always easy for property owners to make decisions.

Yields for retail properties remained stable both in and outside of cities in Q1 (pre-COVID-19). The lowest yield, unchanged compared with October at 2.4%, is still expected for the city of Zurich, followed by Geneva (2.5%, same as October) and Lucerne (2.6%, previously 2.7%). Compared to the prime locations in cities, more rural regions will expect a yield mark-up of around 0.5% to 0.8%.[20] It's not yet clear to what extent the yields will be affected as of Q2 2020. According to our observations, there has been a massive decline in interest in investment properties, particularly retail properties, outside of the prime urban centres [44,45]. Existing strategies for conversion or to generally reduce the proportion of retail property in investment portfolios have become more and more important in the COVID-19 environment. This market sentiment will also find its way into the transaction market and yields will gain ground again.

While stationary retail has been put on the back burner, the digital transformation has continued to accelerate. Buyers have been more or less forced to do their shopping online. A PwC survey conducted in United Kingdom showed that even a few weeks into lockdown, consumers were more open to shopping online, following courses online and enjoying live streaming. 30% said they would shop more frequently online than before and 16% want to continue shopping online in future.[21] Retailers will have to be more aware of the need for shipping and distribution centres. With this structural transformation, there is also greater interest in logistics space, which for some time now has presented an opportunity to diversify real estate portfolios. The top yield in Switzerland is now 4.1%, thus 1.5% to 2% above the level for office properties.[23] It will be left to the investors to judge whether this spread compensates enough for the associated risks.

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[23] CBRE, Logistikimmobilienbericht Schweiz/2020