PwC-Immospektive

Interpretation of the FPRE real estate meta-analysis for Q4/20
References to FPRE graphics in our text are marked with “[1]” etc.

Uncertainty is prevalent in the real estate market, especially in areas of commercial use that are dependent on economic trends.

20 November 2020

The Swiss economy is again showing signs of restraint, after having regained momentum during the summer. A flatter recovery curve is expected. As an asset class, real estate can continue benefiting from the low interest rate environment for some time to come, but in the real estate market there is noticeable uncertainty, particularly in the cyclical areas. Office rents are continuing to fall, and the returns required for commercially used properties are rising. The rental housing segment has been robust so far but has recently also had to contend with lower rents and higher vacancy rates. Investor demand is nevertheless still strong. Revenue forecasts for the construction sector are now decreasing. Only the owner-occupied housing market is remaining unwaveringly positive and is benefiting from the structural transformation.

GDP recovery curve expected to flatten

The Swiss economy regained momentum over the summer. However, the resurgence of COVID-19 infections at the beginning of autumn and the renewed tightening of containment measures in November dissipated the positive mood. The latest developments resemble the negative scenario calculated by the KOF Swiss Economic Institute in October, which predicts a 4.9 % decline in GDP in 2020 and does not expect to see GDP return to pre-crisis levels until 2023.[1] However, all forecasts are subject to a high degree of uncertainty.[2] Approval of a vaccine against COVID-19, for instance, could improve economic development significantly. An unfavourable outcome to the Brexit negotiations, on the other hand, would place an additional burden on the global economy.[3] Expert consensus puts Swiss GDP growth for 2020 at –5.0 %, which is slightly more optimistic than in August, but assumes a slower recovery curve in the following year. For 2021, GDP growth expectations are weaker at 3.9 % (August: 4.5 %) [8], although this is still well above the long-term potential growth of 1.6 % to 1.8 % [9].

Consumption suffers from the interim low on the labour market

Despite the uptick in momentum seen during the summer, ongoing uncertainty kept consumer sentiment subdued.[4] Consumer purchases postponed because of the lockdown have been made up for only partially.[1] The savings ratio is therefore likely to have risen, since employment income fell much less sharply than consumer spending.[5] The unfavourable outlook on the labour market has contributed to this, with employment set to decline and unemployment set to rise further through 2021.[1,4] Immigration will, therefore, be curbed.[6] However, unemployment forecasts improved slightly versus August, with the unemployment rate estimated at 3.7 % (August: 3.9 %) for 2020 and 4.2 % (August: 4.4 %) for 2021 [8]. Experience shows that if the labour market recovers better in Switzerland than in the surrounding regions, solid immigration can be expected again in the next few years [12, 13, 14].[6]

[1] Konjunkturforschungsstelle (KOF), Konjunkturanalyse: Prognose 2020, 2021 / 2020 Nr. 3, Herbst
[2] Schweizerische Nationalbank (SNB), Quartalsheft 2 / 2020 September
[3] Staatssekretariat für Wirtschaft (SECO), Medienmitteilung vom 12. Oktober 2020: Prognose: Wirtschaftseinbruch 2020 weniger stark als befürchtet
[4] SECO, Konjunkturprognose / Herbst 2020
[5] SECO, Konjunkturtendenzen / Herbst 2020
[6] Wüest Partner, Immo-Monitoring 2021 / 1

Inflation set to turn positive again in 2021

The fact that consumption and the labour market, which have been the pillars of the Swiss economy for many years, have weakened means that fiscal and monetary policy measures are all the more important. The Swiss National Bank (SNB) is continuing to pursue its expansive monetary policy and is intervening heavily in the foreign exchange market, partly to counteract the ongoing upward pressure on the Swiss franc and to protect the Swiss export industry.[2] The latter is also heavily dependent on the ability of its main export destinations to recover.[1] The negative inflation rate has moved closer to zero again since hitting a low point in July; this was largely due to the increase in oil prices from the low they experienced in spring.[2,5] Experts still think the inflation outlook is weak and are estimating a drop in inflation of –0.6 % for 2020 (August: –0.6 %). A return to positive territory is expected for 2021 (0.1 %, August: –0.2 %) [8].

Yield forecasts for German governmentbonds and mortgage interest rates remain stable

Yields on 1-, 5- and 10-year German government bonds (–0.72 %, –0.73 %, –0.50 %) have fallen steadily since April, while forecasts have remained stable since the spring. Yields on 10-year government bonds are expected to remain unchanged at –0.5 % for the current year. Expectations for 2021 are slightly higher, between –0.5 % and 0.0 % (August: –0.4 % to 0.0 %) [20, 22]. In contrast, mortgage interest rates declined slightly. The interest rate on a 10-year fixed-rate mortgage in September was 1.23 %, down on the rate in June (1.3 %), while that on a 3-year mortgage was 1.04 % (June: 1.1 %) [23].

COVID-19 is slowing the construction industry down

The sustained low level of interest rates in the past boosted construction activity and caused some imbalances in the ratio of construction contract volume to user demand. With the arrival of the pandemic, a correction has now begun in construction. The coronavirus crisis is unsettling investors, investments are being postponed and the health measures required to combat the spread of the virus are causing productivity losses at construction sites. As a result, the construction index fell by a further 1 % in the third quarter, putting it 8.7 % down on the same quarter of the previous year [17]. In the third quarter, forecasted revenue declined in particular for residential construction (–4.9 %), while the outlook for commercial construction stabilised for the time being at +5.5 % versus the previous quarter. Here the order backlog is still 40 % above the average of the past 10 years, although new orders have recently dropped off. The civil engineering sector is also providing support. Although it saw a decline in the third quarter (–1 %), incoming orders and order books remain promising.[7]

Progress and reorientation are the means to solid revenue in construction

Given the saturation of the market, construction activity is likely to continue declining. The industry is increasingly concentrating on replacement buildings, energy-efficient refurbishments and better use of existing space, rather than on new buildings. Efficiency gains are expected from the building materials and construction methods used and improved construction planning through progressive digitalisation. Thus, the construction industry will regain a foothold in the medium term, despite the recent decline in expected revenue.[8]

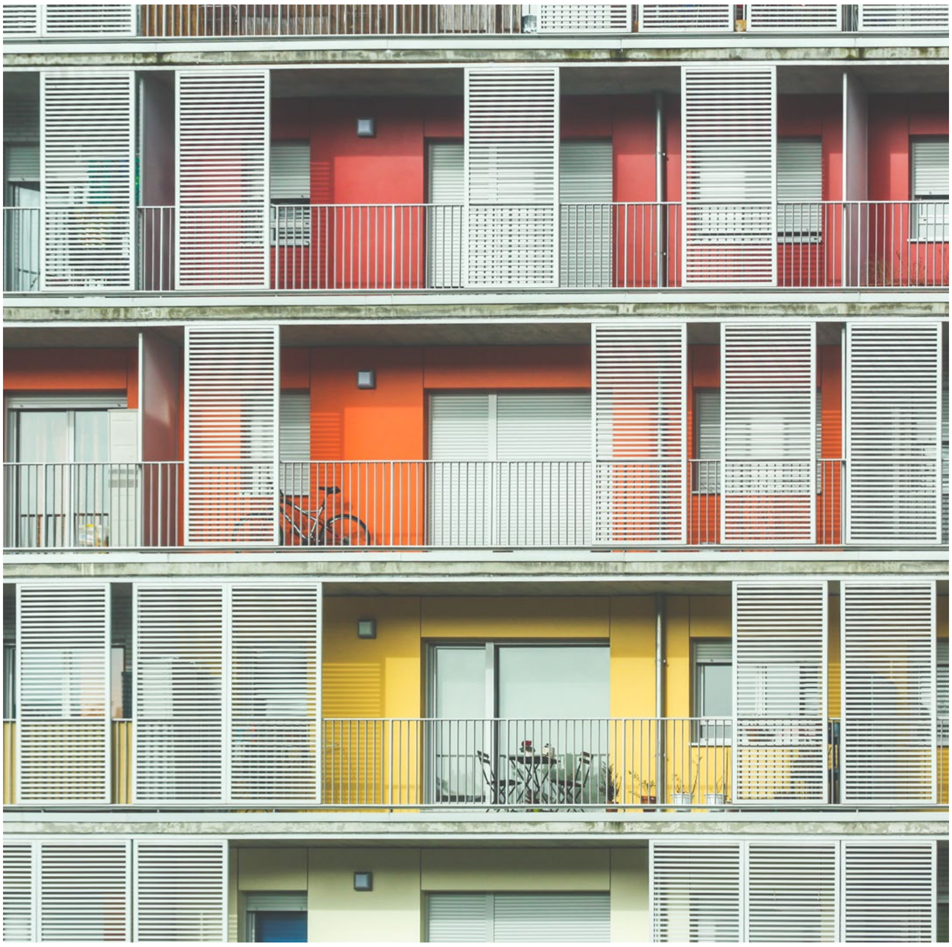
Home ownership is booming in the crisis

The number of home purchases increased in the second and third quarters of the year compared with the same quarters of the previous year. Home ownership has recently become more popular, not only because of the increased need for living space and more private outdoor space, but also because the favourable low interest rate environment generated by monetary policy responses to the pandemic is likely to last longer than originally expected. As the demand

[7] Credit Suisse, Bauindex Schweiz / 3. Quartal 2020

[8] PwC, Schweizer Baubranche: Differenzieren oder verlieren / 2020

for homes grows, a spatial shift can also be observed, with more rural regions and small towns in particular being sought out more frequently than before the pandemic.[6]



Prices on the rise, especially for more affordable residential property

In the third quarter, transaction prices rose by 1.8 % [4, 50, 51]) for single-family homes and fell by 1.2 % [3, 56, 57] for condominiums in Switzerland. The price decline for condominiums occurred solely at the high-price end (–3.7 % versus Q2), while prices in the low- and medium-price segments continued their upward trend. A similar pattern is observable for single-family homes, where the price increases are more pronounced in the low-price segment (+2.4 % vs. +1.7 % in the high-price segment). In regional terms, the biggest changes can be observed in the Lake Geneva region, both for condominiums (–2.4 %) and single-family homes (+3.5 %). Overall, residential property prices are still higher than they were in the third quarter of 2019 (total: +4.8 %; condominiums: +2.9 %, single-family homes: +6.1 %). Only in southern Switzerland is residential property cheaper now than it was a year ago (–1.7 %).[9]

Rental apartments are sought after as an investment – but profitability is declining

The number of building applications for rental apartments has declined in the last twelve months.[10] Meanwhile, vacancy rates continued to rise to 1.72 % compared with 1.66 % in the previous year for Switzerland as a whole. In Switzerland's five largest cities (Zurich, Berne, Basel, Geneva and Lausanne), vacancies were virtually unchanged at around 0.5 %, while increasing to 1.9 % in the rest of the country. The housing vacancy rate is highest in the canton of Solothurn (3.2 %) and the lowest in the cantons of Geneva (0.5 %) and Zug (0.7 %). The increase in vacant housing was most recently greatest in the canton of Vaud.[11] A shift in vacancies is also increasingly observable from new buildings to older apartments.[12]

Rents on the decline and vacancies increasing outside urban centres

In the past quarter, rents (transaction rents) declined accordingly across the board. In Switzerland, rents in the third quarter were 2.6 % lower than at the end of June and 1 % lower than in the same quarter of last year [25, 26]. The decline can be observed for apartments in old buildings (–3 % vs. Q2/20, –0.1 % vs. previous year) as well as in new buildings (–2.3 % vs. Q2/20, –1.7 % vs. previous year). This means that rents are back at roughly the same level as at the beginning of the year.[13] Despite the slight increase in vacancies and the downward trend in rents, the preference for residential investment properties remains high among investors, and yield requirements continued to decline [31]. The minimum real discount rate on a new, mid-sized residential investment property in Zurich fell to 1.93 % in October (July: 1.98 %) [34]. Investors still expect a yield discount of 30 to 50 basis points (bp) for properties in Zurich and Geneva as compared to other Swiss cities. Outside of the urban centres, experts recently noted rising yield expectations for the Zurich region and Central Switzerland.[14]

Office rents continue to fall

Transaction rents for office space are following the downward trend that has been observed since the end of 2019. They fell by a further 4.1 % across Switzerland in the third quarter (Q2: –3.3 %) and are now 7 % below the previous year's figure [2, 35]. The biggest slump is being seen in the cantons of Geneva (–4.4 % vs. Q2/20, –10.1 % vs. previous year) and Schaffhausen (–5.1 % vs. Q2/20, –13 % vs. previous year). Rents have been moving in the opposite direction only in the cantons of Zug (+4.9 %) and Ticino (+1.5 %) for the third consecutive quarter now, up 9 % and 8 % respectively on the figures for the same quarter of the previous year [37].[13] As office rents continue to fall in Switzerland, investors are becoming increasingly cautious about this asset class. With significant yield compression having been predicted prior to the coronavirus pandemic, the expected minimum yields for the cities of Zurich and Geneva have now risen in the last six months by 10 bp (2.3 %) and 20 bp (2.5 %) respectively. An increase is also expected in the cities of Lausanne (2.5 %), Winterthur (2.8 %) and Lugano (3.0 %) on the order of 20 to 30 bp. Outside the urban centres, a premium of up to 40 bp is even anticipated (Zurich: 3.3 %, Lake Geneva region: 3.5 %, Central Switzerland: 3.8 %) with minimum yields. Only the city of Zug is proving robust, with investors expecting yields to be unchanged (2.5 %).[14]

[9] FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 30. September 2020
[10] Credit Suisse, Monitor Schweiz /3.Q 2020
[11] NZZ, Medienmitteilung vom 05. Oktober 2020: In der Schweiz stehen immer mehr Wohnungen leer
[12] Zürcher Kantonalbank (ZKB), Immobilienbarometer / 3. Quartal 2020, Oktober
[13] FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 30. September 2020
[14] PwC, Real Estate Investor Survey, Volume 12/November 2020

Working from home will be more widespread, but creativity and innovation will happen at the office

The COVID-19 crisis seems to have unsettled the players in the office market to a significant degree, as shown by the greater variance reported in expected yields than in previous surveys. This indicates that the impact of the pandemic on the office space market cannot yet be conclusively assessed. That the structural change has likely accelerated is undisputed.[14] For example, a Swiss survey in July showed that 56 % of the companies surveyed assume they will rely more on home office solutions in the future. However, this does not mean that a collapse in demand for office space is inevitable, because at the same time companies are still expecting more success from onsite cooperation and knowledge exchange than from higher home office productivity trends.[15] Once the economy is on the road to recovery and economic growth picks up again, stagnation in the overall demand for office space is likely to set in.[16]

Retail sales results will depend heavily on Christmas business

Seasonally adjusted, real retail sales (excluding petrol stations) in the third quarter exceeded expectations, posting 3.7 % above the previous year. This growth was achieved online in general and offline in selected sectors. Real sales were higher than in the previous year, by 17.7 % in the mail order and Internet retail trade category, 17.9 % in information and communication technology equipment, and 12.6 % in household appliances, do-it-yourself and furnishing supplies.[17] Whether the retail sector's turnover figures will still turn out positive at the end of the year will depend greatly on the course of the pandemic and how prohibitive the ongoing containment measures are in the last two months of the year, which are particularly important for the retail trade.[18] Consequently, physical sales space and retail properties will remain under pressure. Market power is shifting even more in favour of tenants, the only exception being high-street locations. The presentation of merchandise, to draw attention to an associated online shop, for example, is likely to gain in importance against retail space dedicated solely to over-the-counter selling. Repositioning and creativity applied to brands and thus sales space are the keys to survival in the era of COVID-19 and afterwards.[19]

Commercial space in high-street locations proves more robust than office market

Investors are still confident about the viability of retail space in high-street locations. At 2.4 %, the yield requirements for prime locations in Zurich are stable compared to the spring. Projected net yields have however risen during the COVID-19 period in Geneva (2.6 %), Lucerne (2.8 %) and Basel (2.9 %), but investors are reporting only a moderate increase of 5 to 20 bp. High-street locations are thus considered to be more robust than the office market in general. Outside the urban centres, however, investor reluctance remains high, and net yields are expected to continue rising by up to 40 bp.[13]

Authors

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

Nicole Strässle
+41 58 792 43 20
nicole.straessle@pwc.ch

Yan Grandjean
+41 58 792 97 98
yan.grandjean@pwc.ch

Real Estate Advisory
PwC, Birchstrasse 160
CH-8050 Zurich

PwC, Avenue Giuseppe Motta 50
CH-1202 Geneva

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[16] Credit Suisse Immobilienmonitor Schweiz / Oktober 2020
[17] Bundesamt für Statistik (BFS), Detailhandelsumsatzstatistik – vierteljährliche Zeitreihen: Datenstand 30.09.2020
[18] Neue Luzerner Zeitung (NLZ), Medienmitteilung vom 23.10.2020: Schweizer Wirtschaft wehrt sich gegen Lockdown
[19] JLL Artikel online vom 29.10.2020, Retail-Immobilien nach Corona: Neustart statt Rückkehr zum Gewohnten