PwC-Immospektive

Interpretation of the FPRE real estate meta-analysis for Q3/20
References to FPRE graphics in our text are marked with "[1]" etc.

Improvement in customer sentiment but no improvement on the job market

21 August 2020

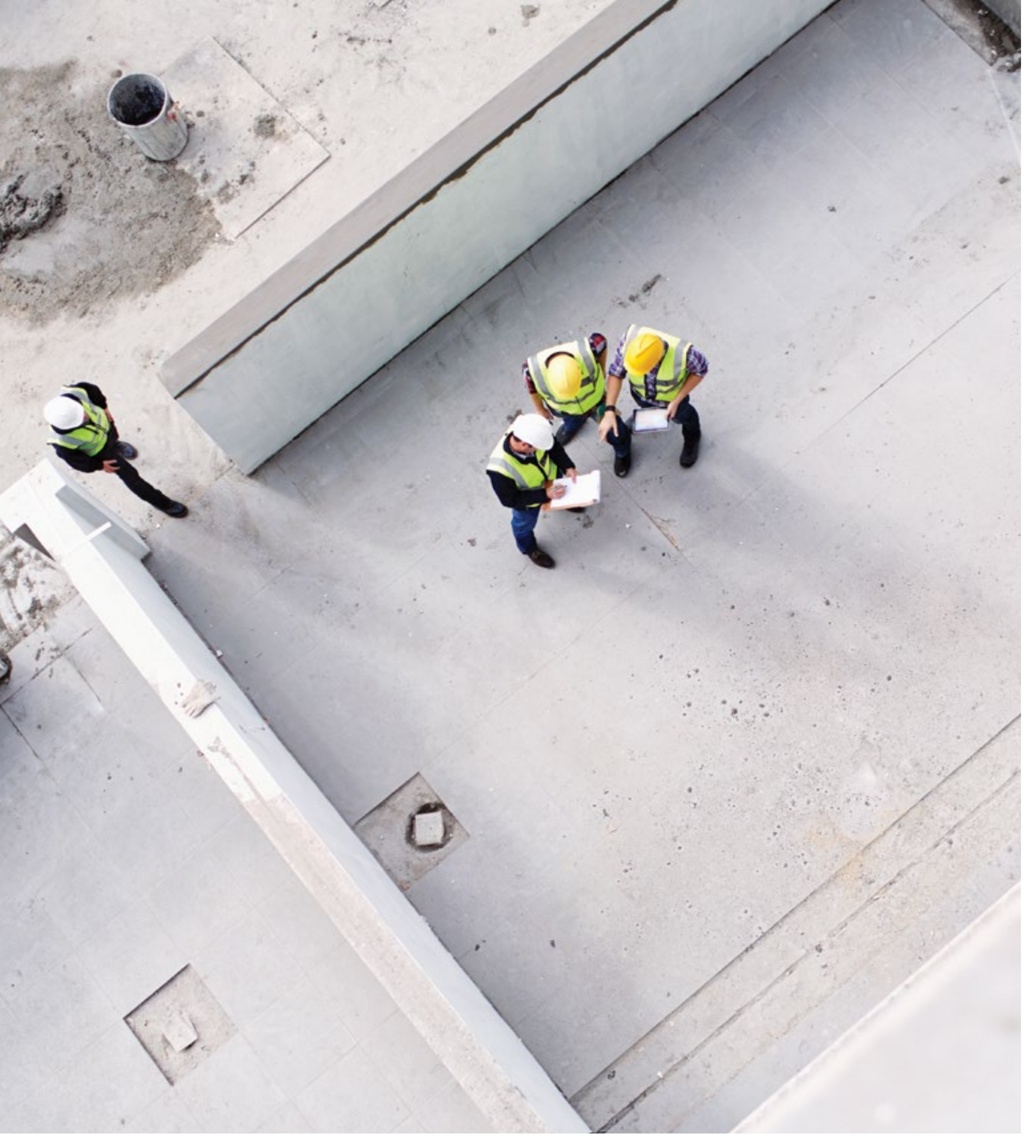
The outlook for the Swiss economy has thankfully picked up again. Although the job market remains under pressure and there's still a general sense of uncertainty. The structural change within the real estate market was accelerated by the pandemic, but the attractiveness of this asset class is still more or less unchanged. Residential investment properties in particular are turning out to be crisis-proof, while retail space is becoming a problem within the sector despite good sales figures. The owner-occupied property market has already recovered from the shock and is currently from the attractive financing environment.

The outlook is brighter

Switzerland has been submerged in a deep recession as a result of the COVID-19 crisis. The restrictions on business and consumption in the spring led to a dramatic slowdown in economic activity, reaching a low point in April.[1,2] Since the first easing of lockdown measures in May, the number of people registered for short-time work is now falling, consumption is picking up again and the outlook has become brighter.[2,3] The increase in government spending as a result of the crisis is supporting the economy, and both retail trade and building construction are now more or less on a par with the previous year's level.[4,5] Having said that, following a turbulent spring, GDP growth for 2020 is predicted to be around -5.8% – a low that has not been witnessed since the oil crisis in 1975. [8] The reason for this is that internationally embedded industries in particular are still suffering from the faltering dynamics of the global economy.[6] How quickly the situation will return to the previous year's level depends on global developments and the fiscal policy support for the economy, with the level of forecasting uncertainty remaining unusually high.[2] Thanks to the expected catch-up effects, the prospects for 2021 are looking good for the time being and the GDP growth rate of 4.5% [8] is higher than the long-term potential growth rate of 1.6% to 1.8% [9].

National service sectors and SMEs are recovering more quickly than expected and customer sentiment is also improving. But consumers are tending to put off making larger purchases.[7] Compared with the previous year, consumer spending is down by around 20%, presumably for reasons of financial security.[3] One reason for this is the bleak prospect on the job market.[7] Employment growth is likely to be low over the next few months, as companies will first start to increase the capacity of employees who are still on short-time work Once the support measures have expired, cases of bankruptcy and redundancies will also be more likely. Accordingly, experts are expecting the unemployment rate to be much higher in 2020 (3.9%) and to continue rising in 2021 to 4.4%, despite the assumptions made in May that the unemployment rate would stabilise [8]. Due to the weakened employment market and the decline in immigration this year [12,13,14], the domestic economy is lacking vital support.[3]

1 Staatssekretariat für Wirtschaft (SECO), Konjunkturprognose / Sommer 2020
2 Schweizerische Nationalbank (SNB), Quartalsheft 2 / 2020 Juni
3 Credit Suisse, Monitor Schweiz /2.Q 2020
4 Konjunkturforschungsstelle (KOF), Konjunkturanalyse: Prognose 2020, 2021 / 2020 Nr. 2
5 Swiss Life Asset Managers, Perspektiven Konjunktur / August 2020
6 UBS Outlook Schweiz, Unternehmen nach der Krise / Juli 2020
7 SECO, Medienmitteilung vom 4. August 2020: Konsumentenstimmung erholt sich deutlich, bleibt aber unter dem Durchschnitt
8 Wüest Partner, Immo-Monitoring 2020 / 2



Negative inflation to persist until 2022

As a result of the decreased growth prospects, the already-low inflation rate hit a new low point in April (-1.1%). The price of both goods and services fell. For the first time since the Swiss franc shock in 2016, the prices of domestic goods also fell, partly due to the discount strategy following the re-opening of the economy.[3,9] The price slump was also largely down to the price of oil. Imported goods became less expensive too.[9] As a result, the SNB's inflation forecast for 2020 is much lower compared to March (-0.7 %, Q2/20: -0.3%). The SNB does not expect inflation to be moderately positive again until 2022 (0.2%, Q2/20: 0.7%) [11].

Neither the SNB nor the ECB opted to further reduce their reference rates as a result of the COVID-19 crisis, unlike during previous crises. After years, a turnaround in interest rate policy is becoming feasible.[10] Yields on government bonds trended similarly to inflation (as low as -1% in 2020 and -0.9% in 2021) in response to the COVID-19 outbreak. However, these

Interest rate lows on government bonds experience turnaround

expectations did not reflect reality, and we can already observe a sideways trend.[10] Estimates have therefore shifted course to -0.5% for 2020 and between -0.4% and 0.0% for 2021 [20,22]. Mortgage interest rates have remained relatively stable over the last few months. The interest on a ten-year fixed-rate mortgage was 1.3% in June (1.4% in March), while that of a three-year mortgage was 1.1% (March: 1.1%) [23].

Civil construction and interest rates continue to underpin the construction sector

The financing environment remains favourable for the time being and continues to be a driving force in the construction sector during the pandemic. What's

Revenue forecast in the construction sector down some 7% on the previous year

more, work at many construction sites was able to continue during the lockdown. This meant that the sector has been less disrupted during the pandemic than other industries.[11] Nevertheless, the already declining revenue expectations in the construction sector are not showing any signs of improvement. The construction index dropped by 2.3% in the last quarter and is 6.7% down year-on-year. The protective measures introduced as a result of COVID-19 and the delays triggered by delivery problems are some of the factors that had a negative impact on development. In addition, the uncertainty at the start of the crisis led to some investments being deferred in the short term or even cancelled completely. To what extent these projects will now recover is still unclear. The fact of the matter is that in March and April, around 10% fewer building applications were submitted compared with the previous year, not taking into account the cantons of Ticino, Vaud, Geneva, Fribourg and Neuchâtel where there was a temporary suspension on the reporting of building applications during the last few months.[12]

In a sector comparison within the construction industry, the expected revenues for structural engineering (-6.5%) and civil engineering (-7%) developed similarly to the previous year. The forecast revenue from economically-sensitive commercial construction came under significant pressure during the last quarter (-8.9%), while expectations in both residential construction and civil engineering only dipped slightly in Q2 by -1.8% [17]. Civil engineering is still enjoying the benefits of a historically high level of orders, and besides the negative interest rates and despite declining development, is an important pillar for the construction industry.[11]

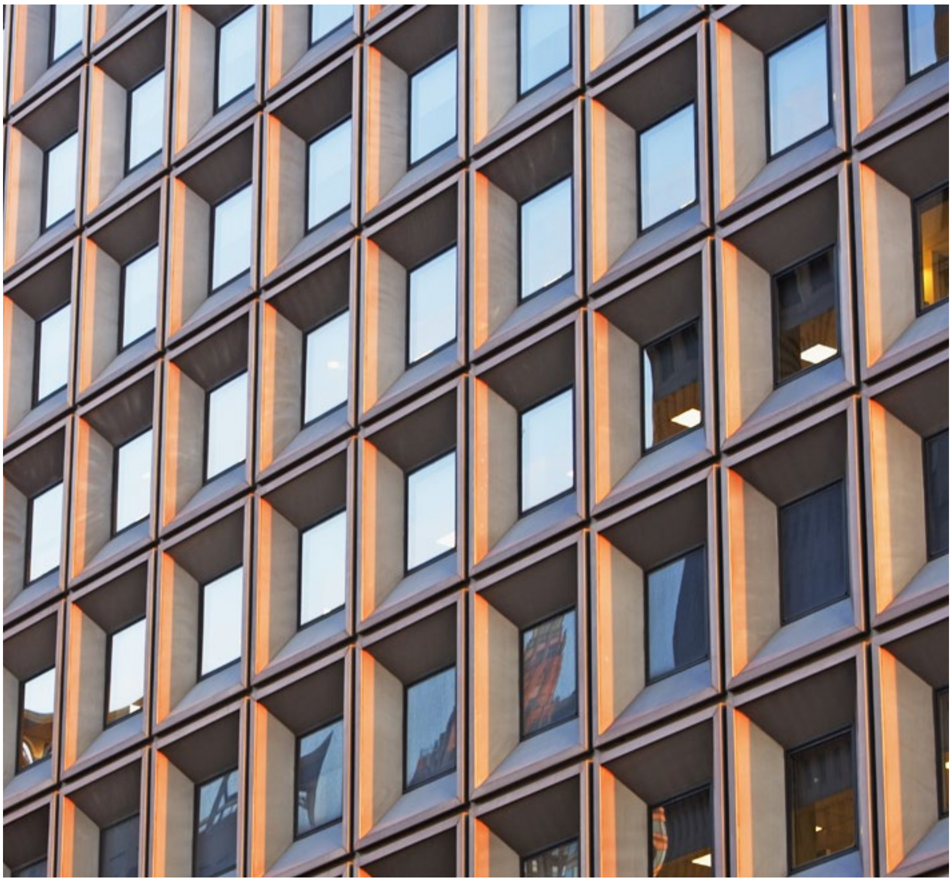
Owner-occupied property market back from its break

The outbreak of the pandemic led to initial caution among the transacting parties on the owner-occupied property market. The number of adverts published for owner-occupied homes plunged by around 30% up to April. Buyers adopted a noticeable wait-and-see approach. At the same time, the crisis led to an increased need for people to have more space in

9 SECO, Konjunkturtendenzen / Sommer 2020
10 NZZ, Medienmitteilung vom 13. August 2020: Vier Jahrzehnte Bullenmarkt an den Anleihemärkten könnten nun enden
11 Credit Suisse, Bauindex Schweiz / 2. Quartal 2020
12 Credit Suisse Immobilienmonitor Schweiz / Juni 2020

their homes and a need for security, which gave a boost to the owner-occupied property market.[11] This trend was confirmed by the number of clicks on sales adverts during lockdown.[13] The shock was also accordingly short-lasting. In addition, a further decline in mortgage costs is expected within the next year and, due to the continued lull in construction activity, this market segment will likely soon reach a normal level again.[12]

After an upswing lasting several quarters, the transaction prices for residential property experienced a slight dip in the second quarter of 2020, but largely still remained above the previous year's value. Prices have remained stable throughout Switzerland (owner-occupied apartments, 0.0% [3,56,57] and single-family homes, +0.4% [4,50,51]). The only decline in prices observed since March has been for properties in the upper price segment (owner-occupied apartments: -2.2%, single-family homes: -1.5%). At a regional level, residential property prices declined in Southern Switzerland (-2.9%), Jura (-0.6%) and the Alpine region (-0.2%), while prices rose in Zurich (+1.2%) and Central Switzerland (+0.9%).[14]



Prices of owner-occupied property remain stable and on a par with previous year

Residential rents on the rise

Residential properties were barely affected by rent defaults as a result of COVID-19 and proved to be crisis-proof overall.[15] Although market participants will expect lower rents over the next 12 months and there has been a noticeable downward trend for some time now, residential rents (transaction rents) even rose by 2.1% in the last quarter [25,30]. As a result, rents are around 2.4% higher than the previous year's level. This rise was observed primarily for old apartments whose rents increased by between 2.9% in Southern Switzerland and 4.6% in the Zurich region in June compared with the end of March. For new builds, rents changed by between -0.5% in Southern Switzerland and +1.95% in the Basel region [25,26].[16]

Residential property investments more attractive, decline in transaction returns

The number of rental apartments on the market grew further last year throughout Switzerland, especially in Western and Southern Switzerland, while apartment-seekers in Zurich were faced with less choice.[8] The demand for housing is supported by the number of households, which is growing quicker than the population.[17] Over the next few quarters, growth in demand will be dampened by the slowdown in the immigration rate. All in all, experts expect the issue with empty properties to get worse and the number of empty properties across the country to increase to around 2.9% by the end of 2020.[8,13]

Nevertheless, the preference among investors for residential investment properties has risen again and yield requirements have further declined [31].[15] The minimum real discount of a like-new, medium-sized residential investment property in Zurich dropped below the 2% mark in July to 1.98% (May: 2%) [34]. The market values of residential properties in the portfolios of institutional investors were in fact evaluated at the end of the first half of the year in June within the context of a recovering market environment. Rent defaults are already a thing of the past and the lower expected returns have led to an increase in value.[15]

Office rents in Zug buck the trend and increase in Q2 by 4.9%

Abrupt halt in the demand on the office space market

Unlike residential properties, properties used for commercial purposes devalued on average by the end of the first half of the year. Along with the reduction in employment, the demand for office space also came to an abrupt halt as a result of COVID-19, and for the time being this is likely to last.[8,15] The absorption times for new office space are speeding up, although new build activity has slowed. This has in turn put advertised rents under pressure. In the short-term though, there is no need to expect widespread rent defaults.[18]

Rents throughout Switzerland fell in the second quarter of the year by 3.3% and have now more or less settled at the previous year's level (-0.1% compared to Q2/19 [2,35]). In the last quarter, office rents (transaction rents) in particular fell in urban cantons like Geneva (-3.8%), Zurich

---

13 Zürcher Kantonalbank (ZKB), Immobilienbarometer / 2. Quartal 2020, Juli
14 FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 30. Juni 2020
15 Schweizer Personalvorsorge / 08–20, Bewertung von Immobilien im Lichte von Covid-19
16 FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 30. Juni 2020
17 UBS, Langfristperspektiven für Immobilieninvestitionen: Schweizer Immobilien / 7. Juli 2020
18 Wüest Partner, Immobilienmarkt Schweiz 2020/3

(-3.7%) and Basel-Stadt (-2.6%) [37]. Prior to this, office rents had risen over several quarters. The decline was less pronounced in rural cantons like Thurgau (-1.7%) and Aargau (-1.2%). The canton of Zug was an exception, where office rents rose by 4.9% between March and the end of June, after declining in the four previous quarters. Similar to Central Switzerland, rents in the canton of Zug are now at the level of the previous quarter (+0.1%).[16]

If the adapted behaviours with regard to living, working and travelling remain unchanged in the long term, the measures introduced as a result of the crisis will have consequences on the office market.[19] As companies were forced to implement digital solutions and new ways of working, the anticipated structural change was sped up by a number of years, and looking back it can be said that COVID-19 gave a boost to technological development.[6] Despite new ways of working and a reduced need for office space, preference will still be given to inner city locations in the office space market, while back-office locations will come under increasing pressure.[15] As a result, the yield requirements in this segment will increase over the next few quarters.

Short-term profits in the retail segment won't solve the retail space issue

The retail sector was able to benefit from the special effects of the crisis in the short term. Within a short space of time, lots of people stocked up on fitness equipment and electronic devices for working at home. The industry also benefited from the fact that certain items could not be purchased abroad. What's more, money usually spent during holidays abroad is instead being spent in Switzerland. In addition, losses made during lockdown were offset by purchases made once the shops reopened.[17] As a result, the real turnover in the retail segment (not including petrol stations) at the end of Q2 was down 2.2% year-on-year – but with significant differences between the goods categories. Sales rose by 27.8% in the retail sector for IT and communications technology devices. Between March and June alone, 14.1% higher real sales were recorded than in the first three months of the year. There were higher real sales in the categories for home deliveries and internet retail (+21.1%) as well as food, beverages and tobacco (+9.2%) in Q2 2020 compared with the prior-year period. On the other hand, the "other goods" category including clothing, pharmaceutical products, watches and jewellery reported a drop in sales of -26.9%.[20] The crisis has also accelerated the structural change – the shift from brick-and-mortar to online shopping – in this segment.[9] The demand for retail space is falling particularly in less frequented locations.[18] So commercial space will continue to have a low level of appeal, and the pressure on space productivity as well as market rents remains unchanged.[17]

Increasing aversion to retail among investors

Investors are continuing to restrict the amount of commercial property investments in their portfolios. Besides low market rents, this is also having an impact on the capitalisation rates which were raised at the end of the year by up to 35 base points for properties with structural issues. Within the retail segment, spaces at high-street locations as well as established and well-functioning shopping centres are still seen in a positive light.[14] The yield mark-up for less attractive locations is up to 1%.[21]

Authors

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

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

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

Real Estate Advisory
PwC, Birchstrasse 160
CH-8050 Zurich

PwC, Avenue Giuseppe Motta 50
CH-1202 Geneva

[19] Immobilienbrief, Ausgabe 304 / 14. Juli 2020
[20] Bundesamt für Statistik (BFS), Detailhandelsumsatzstatistik – vierteljährliche Zeitreihen: Datenstand 31.07.2020
[21] PwC, Real Estate Investor Survey, Volume 11/März 2020