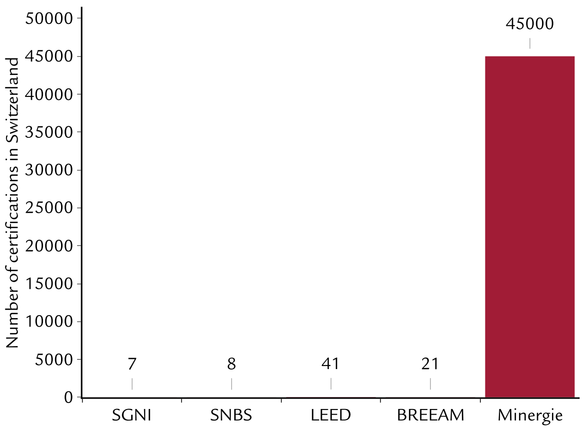
Real Estate House View
Switzerland

First half-year 2020

Key takeaways

- **Steady performance despite economic cooling**: low interest rate environment keeps investors' demand up in real estate and supports overall values.
- **Main urban areas to profit most in commercial real estate:** ongoing polarisation of good regions, locations and assets.
- **Stable average vacancy rates**: further increase expected as current take-up may be temporary – remaining difference between main centres and periphery.
- **Growing risk awareness**: search for niches & new markets due to uninterruptedly high investor demand – emergence of new formats, especially in retail – additional risk with new regulations – main risk is location.
- **Sustainability is here to stay**: ESG and digitalisation established in daily business.

Chart in focus



Source: Minergie (Report 2018), GBIG, BREEAM, SGNI, SNBS

The demand for sustainability labels that not only report on environmental issues is still very small compared to Minergie. Sustainability labels such as SNBS, BREEAM, LEED and SGNI have been used exclusively for properties in premium locations or with an additional representative character. Minergie has covered a broad range of buildings with its more than 45 000 certifications but is coming under pressure due to its clear focus on energy and building materials. The greater attention paid to ESG issues, incl. social issues in particular, is increasing demand for sustainability labels. It is interesting to note that the two Swiss labels SGNI and SNBS are clearly behind the international labels, because of their comparatively low popularity and international investors are focusing on BREEAM or LEED.

Annual GDP growth is forecast from 0.7% through 2019 to 1.3% for 2020 – this could be interpreted misleadingly regarding the economy as GDP gets a boost from major global sporting events, as licence fees generated by organising UEFA and IOC events will enter Switzerland's national accounts as their domicile country. Yet, it is more realistic that the real economy will remain caught up in a slack period in 2020. The manufacturing sector has just emerged from a prolonged period of contraction as signalled by its purchasing managers' index staying below the 50-points expansion line for most of 2019. Mechanical and electrical engineering industries continue to suffer from global headwinds in the form of trade-related uncertainties. Spill-overs into more domestically oriented small and medium sized companies and services sectors are likely to weigh on domestic dynamics and may result in a mild increase in the unemployment rate during 2020.

"Steady as she goes"

The continuing low interest rate environment – we expect the 10-year government bond yield to reach –0.45% by 2022 – should keep up investors' interest in real estate. This will most likely cause values to further increase. As the economy is cooling, demand for space and therefore income is expected to grow less than before. On average, this leads to stable total returns for Swiss real estate in 2020. We are closely watching the developments in valuations, as potential rents and market rents increasingly seem to drift apart: potential rents are not revised in correlation to market changes.

Urban regions benefitting

In summer 2019, around 7% of the entire office space was offered for lease in Switzerland (Wüest Partner (WP)). The cooling economy combined with various trends such as desk sharing and home office have led to a lower demand for space. The increase in supply materialises from new construction in past years. On average, demand is expected to be stable, given the recent employment growth, yet dampened by a slowing economy. WP expects office rents to increase by 0.2% in 2020 – confirming our cautious assessment. Cities like Basel, Lausanne and Zurich, but also other larger rural areas will be the ones profiting the most. Yields have decreased again and are expected to do so further in the main metropoles. Outskirt offices will see only stable developments at best.

Polarisation ongoing

With the low interest rate environment, the Swiss franc is likely to remain strong against the euro – resulting in Swiss consumers continuing to spend money abroad. Combined with growth in online shopping, this still offers difficulties to the retail sector. As a consequence, retailers have been decreasing their space. Expansion plans are mainly taking place in larger cities, so that middle-size locations are hardly profiting. Location remains key, where good locations can vary by the metre. New formats and pop-up stores are increasingly to be found in newly vacant spaces. Yet WP expects rents to decrease by –1.5% in 2020.

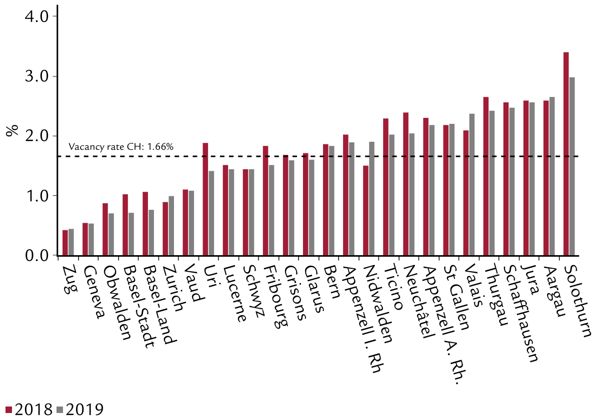
Residential vacancy still topical

The residential vacancy rate only increased marginally from 1.62% in 2018 to 1.66% in 2019. According to WP, this obscures the actual developments slightly as the increase is due to temporary peculiarities and new trends: growth of single households has increased disproportionately – the Swiss population is thus spread across more households. Yet, the vacancy rate is set to increase further as supply prevails over demand. Immigration, one of the leading drivers for demand, has decreased markedly and is expected to remain at lower levels. Overall, these developments will lead to further decreases in initial rents, –0.9% in 2020 according to WP. In addition, the reference interest rate is expected to be lowered again in March 2020.

Regulation density increasing

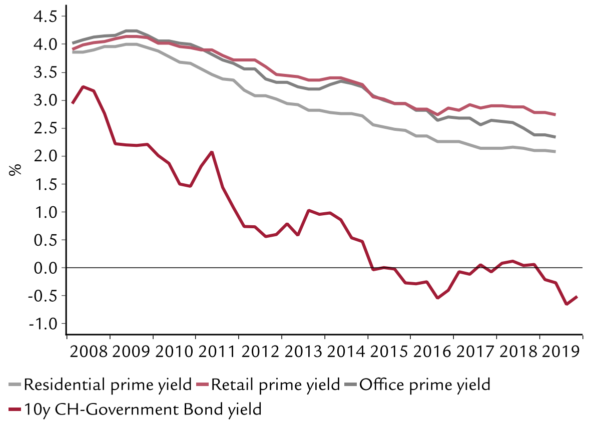
While choice of location continues to be the main risk for investors, regulations are increasingly adding to the risk. Especially in the residential sector, local (e.g. Basel) and national (e.g. vote for more affordable apartments in February) socio-political initiatives are impacting project developments. Furthermore, sustainability requests from investors need to be implemented - slowly becoming ingrained in the strategy and holistic thinking of real estate owners.

Chart 1: Residential vacancy rates by canton



Source: Federal statistical office (BfS)

Chart 2: Prime yields and government bond yields



Source: Wüest Partner, Macrobond

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