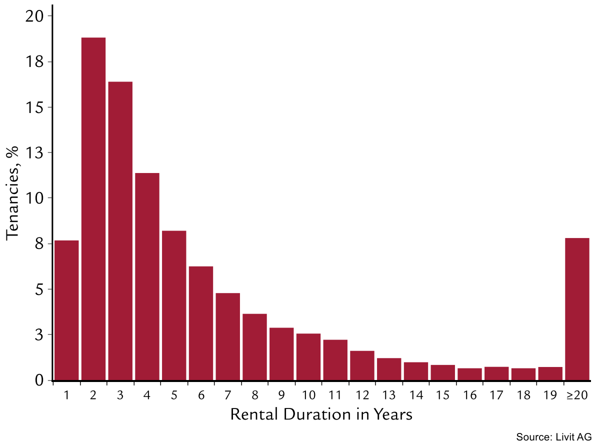
Real Estate House View
Switzerland

First half-year 2019

Key takeaways

- Swiss real estate investments remain popular among investors. The attractiveness of the high risk spread seems to be clouded neither by structural changes in the office and retail sector nor by vacancy rate increases in the residential sector.
- Vacancy rates in the residential sector increased again by June 2018, revealing stark polarisation between urban and peripheral areas as well as between the rental and the privately owned sector.
- The office sector has normalised somewhat, with some shorter negotiation periods and longer leases observed in CBD areas. Large increases in supply need to be monitored (e.g. Zurich and Geneva).
- Retailers remain cautious and changing consumer behaviour is maintaining pressure on rents.
- Economic developments are not considered as supportive for the real estate market today as they were in the past.

Chart in focus



The residential market is highly dynamic with respect to moving house. About 25% of the households that moved out in 2018 stayed less than two years in their previous apartment. Compared to 1- and 2-room units, tenants stay significantly longer in 3-room apartments. The longer a tenant stays, the bigger the gap between the rent of the current and the potential new apartment. After some years, therefore, it is advantageous to stay in the current flat. While a dynamic market creates many opportunities to find new tenants, it is difficult to hold on to existing tenants.

GDP contracted 0.2% in the third quarter 2018 on weak export performance. New orders in the mechanical and electrical engineering industries fell by 12% in the same period on a seasonally adjusted basis. While slower order intake in these sectors is a mirror image of softening growth dynamics in the world economy, domestic consumption is going through a soft patch as well, with retail sales stagnating. These drags are likely to persist and are expected to weigh on growth next year. A further reason for prudence is that migration will no longer boost activity by the same amount as in the last decade: compared with the years 2013 to 2015, some 33,000 fewer people will have migrated to Switzerland on balance in 2018. As a consequence, quarterly GDP growth rates are expected to halve over the coming quarters compared with the average since mid-2016.

Keen to invest

While the economic outlook is deteriorating, the recent economic recovery has supported the real estate market in Switzerland and is expected to continue doing so in the short term. The relatively favourable economic environment combined with ongoing low interest rates is reflected in the level of activity on the real estate market. At about 25 to 30 bps, the risk premia remains relatively high compared to other assets and investors are still keen to invest in the Swiss real estate markets. This is despite structural changes in the office and retail sectors as well as an increased vacancy rate in the residential sector. The resulting willingness to pay supports overall performance, while we expect potential rents to be revised downwards. Overall, the performance for 2018 and 2019 should again be lower than the 5.9% in 2017 according to MSCI.

Residential vacancies increasing

The increased vacancy rate in Switzerland remains a widely discussed topic. By June 2018, 72,294 apartments were vacant nationally, which corresponds to a vacancy rate of 1.6%. Compared to the year before, an additional 8,020 apartments were vacant, an increase of 13%. In the rental apartments segment, which saw the biggest rise in vacancies, 2.6% of properties were vacant (Wüest Partner). The geographical differences are marked: in some more peripheral areas vacancy rates of more than 10% can be observed but rates are lower than 0.5% in the main cities. This reflects the tendency for construction activity to remain strong even when demand is low. Given the low interest rate environment, we expect this trend to continue, though at a lower level. Furthermore, the economic upswing is not strong enough to add any demand-led stimulus. With immigration growth falling, both fewer and less solvent immigrants are moving to Switzerland. Combining these factors, rents are expected to decrease in the course of 2019 by 1.5% according to Wüest Partner. As the residential market becomes more challenging, we see secondary properties such as parking spaces receiving more attention. Demand for parking is very stable: despite an increasing number of car-free households and the trend to home-office working, the number of rented parking spaces per apartment is virtually the same as ten years ago.

Normalisation in office markets

The recent sound economic environment has increased employment in Switzerland and impacted positively on the office markets, especially in CBD areas. Negotiations thus became easier and lease terms lengthened again in 2018. But the letting market remains challenging in less sought-after locations. With large office supply pipelines in some areas like Zurich and Geneva, the economy is unlikely to be strong enough to absorb all of the additional space. This decreases the pressure on rents and prices, though only slightly. The vacancy rate has now been elevated for some time and it remains very low compared to other European countries. Nevertheless, the market is still tenant-friendly, especially outside the city centres. We expect the office markets in Switzerland to remain flat.

Tit for tat in the retail sector

Structural changes in the retail sector are still ongoing. While we strongly believe that bricks and mortar retail will endure, there remains a lot of retailer uncertainty. The growth of online retail is forcing retailers to use a trial-and-error strategy regarding how much space is needed, with a tendency to close down shops or move if rents are too high. Overall, we expect additional pressure on rents, even in good locations with Wüest Partner forecasting a 2.5% rental value reduction in 2019.

Chart 1: Construction permits for multi-family homes

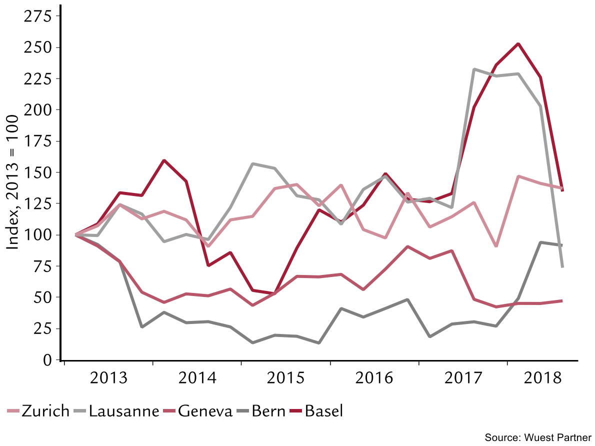
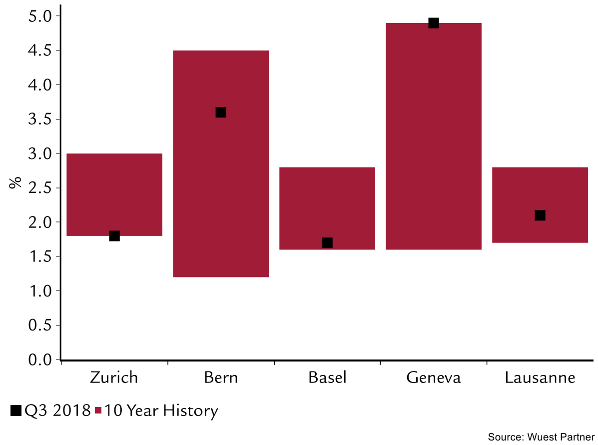


Chart 2: Office vacancy rates



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