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Growing organically

Unlocking value in existing real estate | White paper

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Transaction yields in the Swiss property market are persisting on a downward trend. This is widening the income return spread when compared to already invested stock. In addition, growing urbanization pressure and sustainability requirements are supportive of transformation projects of existing real estate.

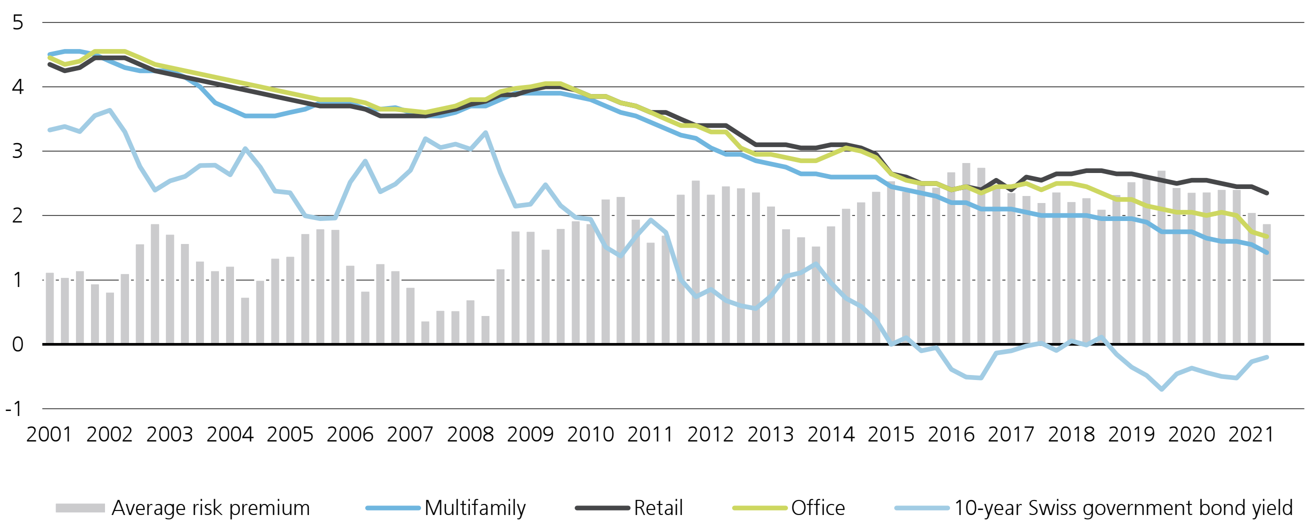
Economically, socially and environmentally sensible

Active management strategies, ranging from simple refurbishments of existing buildings to more complex site re-developments, can unlock untapped potential in existing real estate.

Swiss properties remain attractive
In the current low interest rate environment, Swiss investors still favor local real estate assets given their capacity to provide stable income returns. This trend actually started many years ago and led to the steady compression of the transaction yield level for Swiss property investments (see Figure 1).

In the first half of 2021, net initial yields in the prime multifamily sector compressed by 17 basis points (bps) to reach 1.43% according to data from Wüest Partner. Despite remaining uncertainties from the pandemic, transaction yields compressed in the prime commercial sectors as well. The retreat has been particularly pronounced for prime office assets, with a 32 bps compression to reach a new low of 1.68% for this sector. Net transaction yields evolved on a downward trend in the prime retail sector as well, but with a limited retreat of 10 bps.

Figure 1: Net yields and risk premium in the transaction market for prime Swiss properties (%)



Source: Wüest Partner 2Q21; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), October 2021

Transaction market set to remain competitive
Despite initial yields compressing to record low levels, prime Swiss properties still offer a risk premium slightly above the historical average. At the end of 2Q21, an average prime Swiss real estate transaction offered a spread of 1.9% compared to the yield obtained on a 10-year Swiss government bond. Economic risks from the pandemic, the modest inflation dynamic in Switzerland (despite important base effects from 2020), as well as the strength of the Swiss franc are factors which point to a continuation of the negative interest rate policy led by the Swiss National Bank.

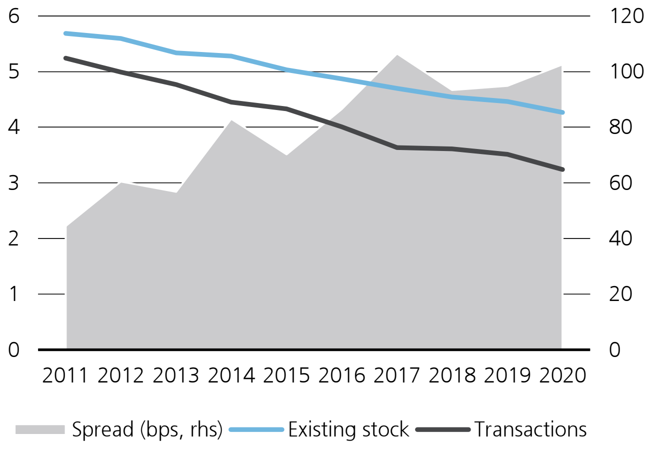
With this in mind, the bond market is expected to remain challenging in the coming quarters with low or negative yields. At the same time, Swiss properties are set to remain an attractive investment alternative. In this context, we will likely still see strong competition going on in the Swiss property transaction market in the foreseeable future.

Current capital flows for indirect property investment structures support this scenario. According to Safra Sarasin, more than CHF 3.5bn of debt and equity capital have been raised by Swiss property funds, investments foundations and listed property companies in the first three quarters of 2021.

Widening yield gap between acquired assets and already invested stock
The increasing investor interest in Swiss property is also reflected in rising values of existing real estate portfolios. This is driven by the constant retreat of the discount factors in property valuations. Due to the price increase, portfolio yields are driven downward, albeit in a more gradual way when compared to the dynamic of the transaction market.

This gradual pricing approach, which is typical of Swiss valuation culture, widens the income return gap between already invested properties and newly acquired assets. According to data from REIDA and Meta-Sys AG, this yield spread amounted to over 100 bps during 2020 (see Figure 2).

Figure 2: Gross yield and spread between the transaction market and already invested assets (%, mixed sectors)

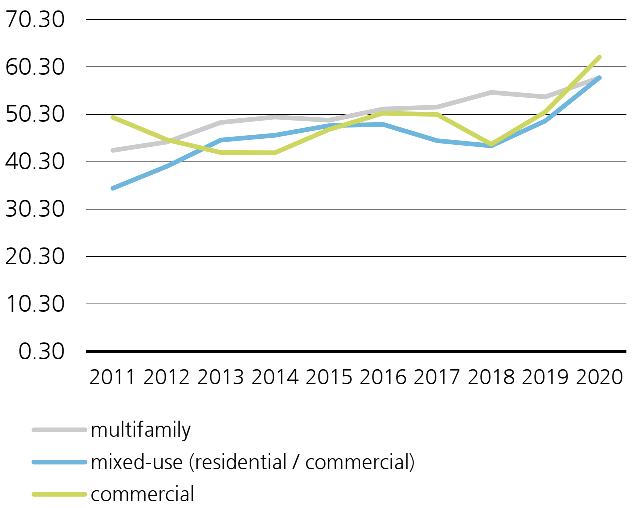


Source: REIDA, Meta-Sys AG, UBS Asset Management, Real Estate & Private Markets (REPM), October 2021

Location price as an increasing barrier
The widening income return spread between already invested assets and the transaction market supports the focus on existing real estate. The growing burden of securing a location in the transaction market is another factor which supports a focus on already invested assets, i.e. through refurbishment and construction projects. Data from Zurich City's statistics department illustrates this trend (see Figure 3). Over the last 10 years, the estimated share related to the land price in total transaction costs moved significantly upward in this market. At the same time, a similar trend can be observed on a national level from concluded transactions.

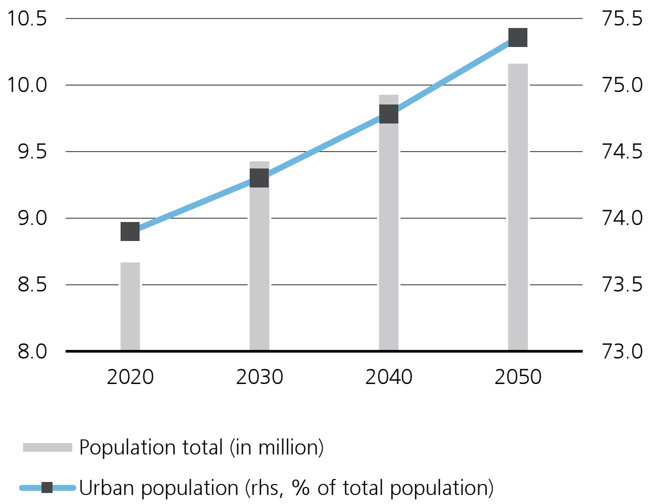
Increasing land prices and decreasing transaction yields speak for more transformation strategies in existing real estate.

Figure 3: Securing a location becomes more expensive
(%, estimated land cost share in total transaction prices in the city of Zurich, 3-year rolling average*)



Source: Statistics City of Zurich; UBS Asset Management, Real Estate & Private Markets (REPM), October 2021. Notes: Median total transaction price minus property insurance value as a percentage of median total transaction price.

Figure 4: Increasing Swiss population and urban character



Source: Forecast from Oxford Economics 2021; UBS Asset Management, Real Estate & Private Markets (REPM), October 2021

Tackling the urban sprawl challenge

Investing in existing real estate does not only make sense from an economic perspective, as explained in previous pages. It is also a crucial element to address growing sustainability challenges, such as the urban sprawl phenomenon triggered by demographic and urbanization pressures in Switzerland (see Figure 4), as well as extensive urban planning (i.e. extension of building zones outside the built environment).

The Swiss legislator and voters addressed this increasing challenge by drafting and accepting a new version of the Spatial Planning Act, which became effective in 2014. This regulation focuses on future urban development within the boundaries of the existing built environment. It also created the foundation for the revision of cantonal structure plans, the majority of which have been achieved and approved. These structure plans define, via a spatial concept, the regional focus of future population and economic growth. As such, this drives the future development of the existing built environment.

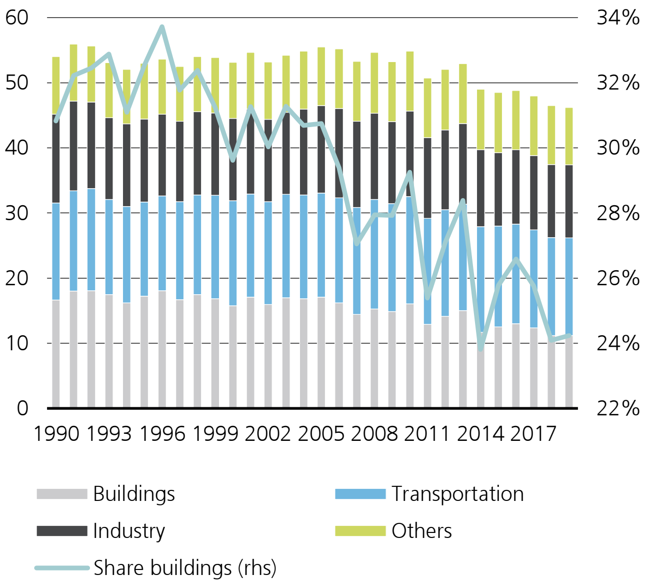
The new spatial guidelines lead to binding incentives for local municipalities and property owners to work on the existing urban stock to unlock further development potential, while avoiding the sprawl of the built environment. This avoids further consumption of agricultural land and the progressive destruction of valuable ecosystems.

Climate action calling for modernization of real estate

Aside from the shift towards more sustainable land use, the fight against climate change is another prominent environmental, social and governance (ESG) theme calling for more investment into existing real estate. Despite the declining trend over the last 20 years, real estate still accounts for about a quarter of Switzerland's greenhouse gas emissions according to the latest data available (see Figure 5).

With this in mind, modernization projects of existing buildings are prerequisites to comply with goals to reduce greenhouse gas emissions defined in the legally binding Paris Agreement to tackle the global climate challenge. As an example, this could include the replacement of a fossil fuel-based heating system or improved building insulation.

Figure 5: Building stock remains a significant greenhouse gas issuer (Swiss emissions, million tons of CO_2-equivalent)



Source: Federal Office for the Environment; UBS Asset Management, Real Estate & Private Markets (REPM), October 2021

ESG requirements go beyond energy efficiency
When addressing ESG concerns, real estate investors need to account for numerous property-related aspects which go far beyond energy efficiency concerns. Building security, tenant wellbeing and quality of shared spaces inside and outside of properties are just a few examples of environmental and social factors to be considered in a holistic sustainability approach in the realization of transformation projects. Also, the integration of new building technologies such as sensors, may contribute to addressing the aspects mentioned above and monitoring the progress towards a more sustainable real estate portfolio.

From top-down portfolio analytics to bottom-up project specifications
As explained in the previous pages, the case for investing in existing property stock is supported by a strong economic, social and environmental rationale. When working on a sizeable real estate portfolio, investment managers may face challenges in identifying the most sensible active management strategies. In Figure 6, we present a potential roadmap to identify and implement these strategies.

The first step of the value-chain consists of screening the portfolio to identify untapped construction potential in standing assets and to assess future prospects of the invested locations. This involves comprehensive market research as well as the identification of ESG deficiencies of invested real estate.

Furthermore, neighboring properties may be considered in the analysis as well, for instance in the context of a potential acquisition or to partner with other owners when a larger re-development could make sense. At the end of this step, a shortlist of the most promising assets to transform will be defined. This selection will then be treated as priority in the next steps of the process.

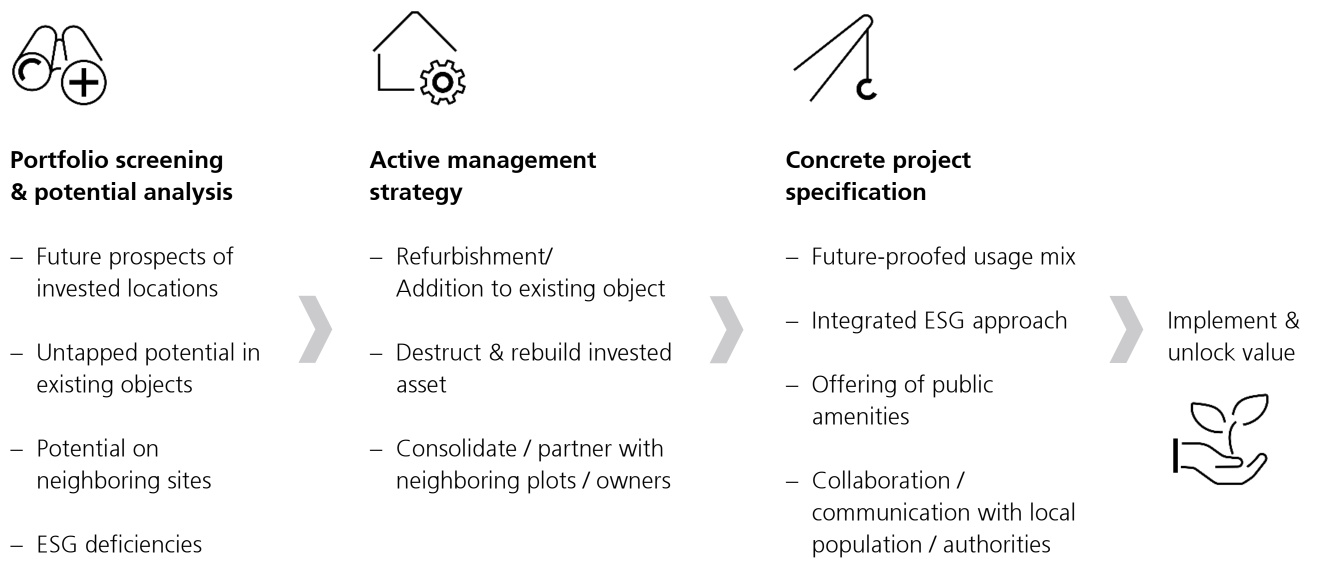
As a next step, the investment manager needs to identify the most sensible construction strategy for the specific asset to be transformed. The strategy may go from limited refurbishment works accounting for growing ESG requirements, up until the addition of further buildings and property floors, or even a complete re-development project of the existing property. In the latter case, the acquisition of adjacent properties or partnerships with neighboring owners may make sense in order to enhance the positive impact and benefit the transformation project.

Consider new tenant requirements and public infrastructure needs

The third step of the roadmap is dedicated to the concrete definition and planning of the construction project. In the case of a large-scale redevelopment, smooth and comprehensive communication with the authorities and the population is key to ensure the suitability and acceptance of the re-development project within the local community. Other important elements of this step are the integration of an holistic ESG approach and the definition of the target usage mix of the future property, in the case of building addition or re-development projects.

New tenant requirements, such as barrier-free conditions for the growing client segment of independent seniors, as well as potential public and social infrastructure needs (e.g. kindergartens or schools) need to be considered in this definition. Once this step has been concluded, the project will enter in the realization phase, where the untapped potential of the existing building stock will be finally unlocked for the benefit of the property investors as well as the society as a whole.

Chart 6: Roadmap to actively manage existing property stock



Source: Interview with Joris Van Wezemael 2021 (Ivo Innenentwicklung AG), UBS Asset Management, Real Estate & Private Markets (REPM), October 2021

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