

Real Estate Outlook

Switzerland – Edition 1H21



Recovery or re-take?



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Despite the challenging environment, Swiss property investments delivered a **robust performance in 2020.**



The second wave of COVID-19 triggered a bounce back of uncertainty in the Swiss real estate market. However, occupier market fundamentals remain resilient and the rollout of the vaccination campaign is raising hope for a gradual normalization of the sanitary and economic conditions in a close future.

Macroeconomics

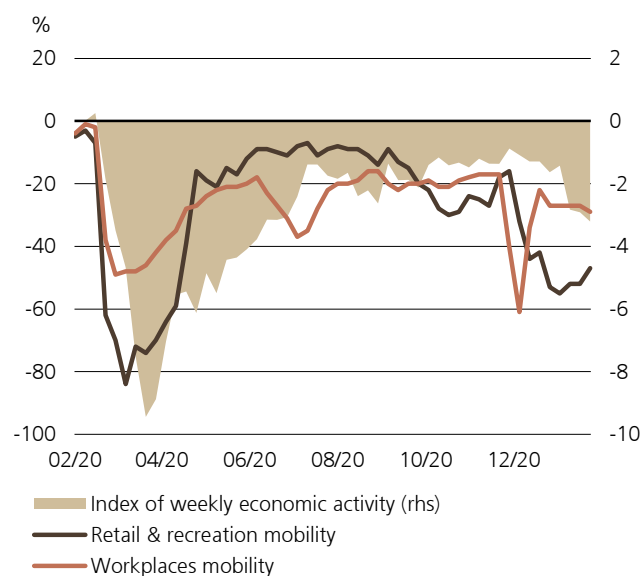
Resilience despite the second wave

Vaccination roll out raising hopes

Following a very calm summer break, the COVID-19 virus made a blasting come-back in the second half of 2020. The second wave of infections triggered the reintroduction of strict social distancing measures all around Europe, which culminated in a second lockdown during winter. Compared to the first wave of Spring 2020, economic activity seems to have remained much more resilient in these adverse conditions. According to the Swiss weekly economic activity index, the second lockdown led to a pause in economic recovery, but did not trigger a sharp GDP contraction like during the first wave of infections (see Figure 1). This may be explained by the slightly less restrictive nature of the second lockdown, as well as the gradual adaptation of economic players and consumer habits to the pandemic environment.

Despite supply constraints causing a very slow start on the European continent, the rollout of the vaccination is raising hopes for an approaching end to the health crisis.

Figure 1: Mobility report and weekly economic activity index vs. baseline*



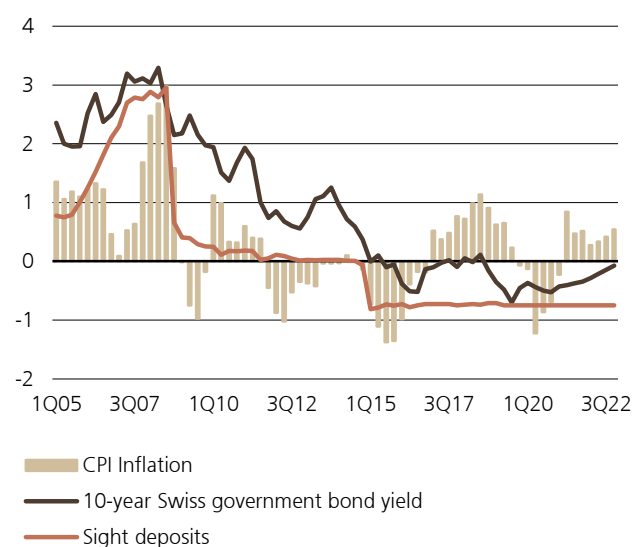
Source: Google, State Secretariat for Economic Affairs; UBS Asset Management, Real Estate & Private Markets (REPM), March 2021
Note: *Baseline Weekly economic activity – Growth rate of real, seasonally, calendar and sport adjusted GDP in the same quarter of the previous year; Baseline Mobility – Median value, for the corresponding day of the week during the 5-week period 3 Jan-6 Feb 2020.

As a result, Swiss economic activity is expected to bounce back from 2Q21 onwards, as lockdown measures gradually ease and vaccination campaigns gain more and more traction. According to recent estimates, Swiss real GDP is expected to rebound by 3.5% in 2021, after a 3.0% contraction in 2020.

Foundations of the low interest rates still in place

In light of this expected economic recovery and elevated energy prices, inflation dynamics are likely to pick-up in the course of 2021, but starting from a very low level (see Figure 2). Despite some potential short-term peaks, current forecasts are seeing an average inflation level of just 0.7% in Switzerland in 2021, and 0.3% in 2022.

Figure 2: Inflation and interest rate environment (%)



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

Although the economic outlook seems to be brightening up, there are still some downward risks due to the pandemic which cannot be ruled out just yet. This prevailing uncertainty and the modest inflation prospects signal that the current macroeconomic conditions remain supportive of a continuing low interest rate environment in Switzerland. Therefore, bond yields are likely to persist at subdued levels in the coming quarters, despite a recent surge triggered by reflation fears.

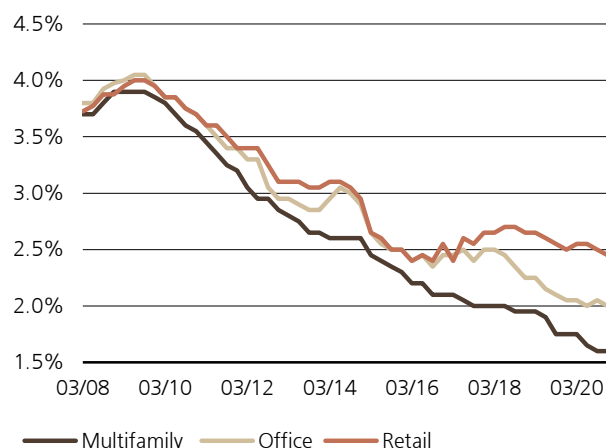
Investment market

Demand for property remains buoyant

Initial yields continuing on a downward trend

The persisting low yield environment continues to fuel investors' demand for Swiss real estate. This strong interest had led to a retreat of initial yields in the transaction market, particularly in the prime segments. During 2020, prime multifamily cap rates compressed by 15bps to reach a level of 1.60% at the end of the fourth quarter (see Figure 3). Despite the elevated level of uncertainty caused by the pandemic, net initial yields retreated in the prime office (2.00%) and commercial (2.45%) sectors, but with a more modest dynamic (-5bps).

Figure 3: Net initial yields in the prime segment



Source: Wüest Partner 4Q20; UBS Asset Management, Real Estate & Private Markets (REPM), March 2021

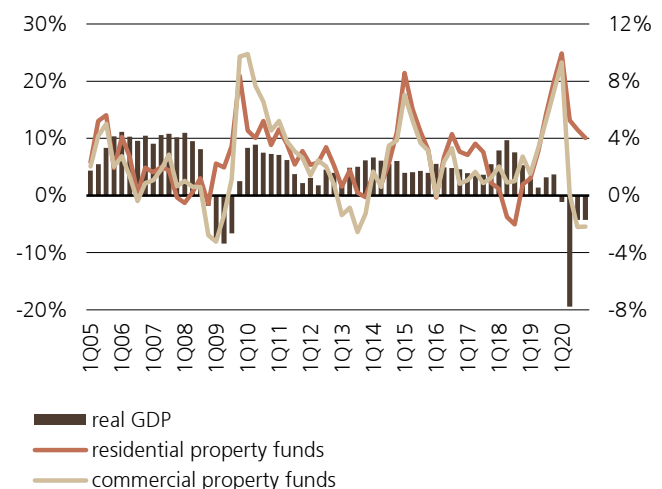
Notwithstanding increasing property prices and a slight rebound of bond yields, the risk premium of direct real estate assets remains elevated. As of 1 March 2021, the average yield differential between the acquisition of a prime property and a 10-year government bond amounted to 2.2% in the Swiss market, i.e. 50bps over the historical average. In our view, this elevated spread is likely to continue to fuel both investor interest and transaction activity in the coming quarters.

Commercial funds to rebound with the economy?

The dynamics of real estate investment vehicles further illustrates strong investors' appetite for Swiss property. According to JLL, 2020 has been a very strong year for capital raising campaigns, with over CHF 4 billion collected by investment foundations, listed funds and real estate companies. Furthermore, the average agro level of the Swiss real estate fund market reached almost 34% at the end of February 2021.

However, investor enthusiasm appeared to be unevenly distributed in the listed property fund market in 2020, when looking at specific sectors. While residential products have been well sought after due to the resilient nature of the Swiss multifamily market, funds investing in commercial properties have been hit by a negative investor sentiment. The correction of commercial funds during periods of retreating economic activity is unsurprising and has been observed during past crises (see Figure 4). Therefore, it is reasonable to assume that listed commercial products will gradually recover once economic recovery gains more traction. However, this largely depends on investors' judgment on the long-term consequences of the pandemic – especially given the potential increase in e-retail and home-office activities.

Figure 4: Total return of Swiss listed property funds (YoY growth, quarterly data)



Source: Refinitiv, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), March 2021. Note: Products launched before 2000. Past performance is not a guarantee for future results.

Occupier markets

Pandemic impact remains limited so far

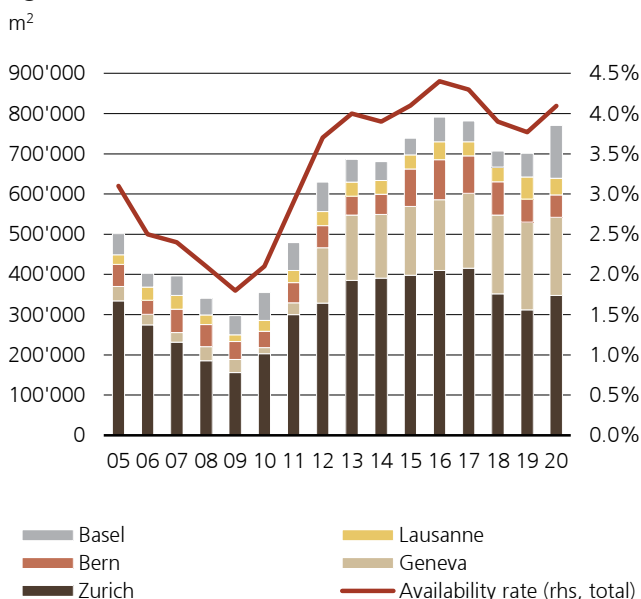
Multifamily: Steady as she goes

The Swiss multifamily sector is still showing resilience amid the global pandemic. In 2020, the absorption potential in this sector remained robust as net migration increased 12% YoY to reach a level of over 61,000 people. However, construction activity persists at an elevated level. According to Documedia, about 45,000 residential units received a building permit in 2020, mainly in the rental sector. Therefore, the level of new supply is likely to keep overshooting demand in the coming quarters. This is expected to keep offering rents under pressure in the multifamily sector going forward. However, we expect rental prices to remain more stable in core urban centers and their agglomerations, given that market fundamentals are still relatively strong in these locations.

Office: Close monitoring required

Despite the pandemic disruption, fundamentals of the Swiss office property market remain quite stable so far. According to JLL, the number of available office spaces in Switzerland's five largest markets increased slightly in 2020 to reach an offering rate of ca. 4.1% of overall stock (see Figure 5).

Figure 5: Available office surfaces



Source: JLL Research; UBS Asset Management, Real Estate & Private Markets (REPM), March 2021

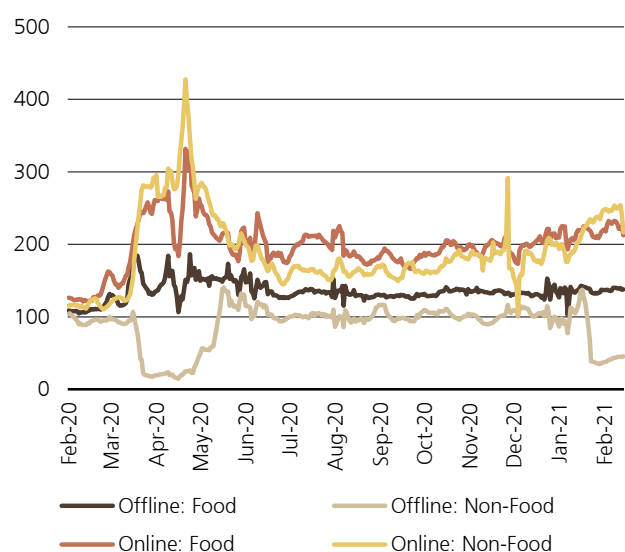
The moderate softening of the fundamentals primarily affects decentral business districts, such as Opfikon/Glattbrugg in the Zurich market. According to Wüest Partner, average offering rents are currently trending sideways, with a 0.2% YoY growth reported in 4Q20. Going forward, a close monitoring of Swiss office market fundamentals is required, particularly given the trend towards more home-office activities, and a substantial pipeline of new office projects which may weigh on the market's balance and future rental growth prospects.

Retail: Second lockdown raises downward risks

The second lockdown led to increasing uncertainty in the Swiss retail property market, as many non-food stores experienced a sharp retreat in sales volume following the restrictions (see Figure 6). By contrast, food retailers enjoyed a positive development due to increasing home-office activities. Despite the gradual lifting of the lockdown measures, the harsh stress test experienced by many retailers is likely to keep retail property rents under pressure in the coming quarters. Differences will be apparent depending on the quality of the property and the sector focus of the retail tenants.

Figure 6: Retail sales volume

(Index, 7-day moving average, 100 = value a year ago)



Source: Monitoring Consumption Switzerland; UBS Asset Management, Real Estate & Private Markets (REPM), March 2021

Note: Data from mobile, credit and debit card payment services.

Return forecasts

Brighter near-term outlook

Robust performance despite the pandemic shock

Despite a turbulent environment, 2020 has largely been a positive year for the performance of Swiss real estate investments. The dynamic transaction market (as referenced in page 5 of this document) and the persisting low yield environment led to a further compression of the discount factors of property valuations. This supported robust capital value growth, particularly in the case of multifamily assets.

This resilience exceeded our expectations from last Summer, leading to an upward revision of our near-term outlook in terms of total return (see Figure 7). However, this revision does influence the timing of the expected performance, but not the average yearly level over the period 2021-2025. For a mixed allocation, we still expect an average total performance of 3.7% p.a. over this 5-year horizon.

Investor pressure lifting multifamily assets

The defensive nature of the multifamily sector continues to drive strong investor interest in these uncertain times. In our view, this investment pressure is likely to lead to more capital value growth driven mainly by discount factor compressions, as the near-term rental growth outlook remains rather muted. Therefore, we expect multifamily investments to outperform the market average over the next 3 years, with an average total return prospect of 4.5% per year.

Office assets: Dynamic expected to cool down

Before the COVID-19 outbreak, the Swiss office market was gaining traction in terms of both occupier demand and investment activity. However, the outlook has become uncertain due to the long-term consequences of the pandemic. For example, increasing home office activities could weigh on rental growth prospects going forward. This uncertainty is likely to temper investor sentiment for this sector in the near-term, which leads to a slight downward revision of office capital value growth prospects in our forecasts.

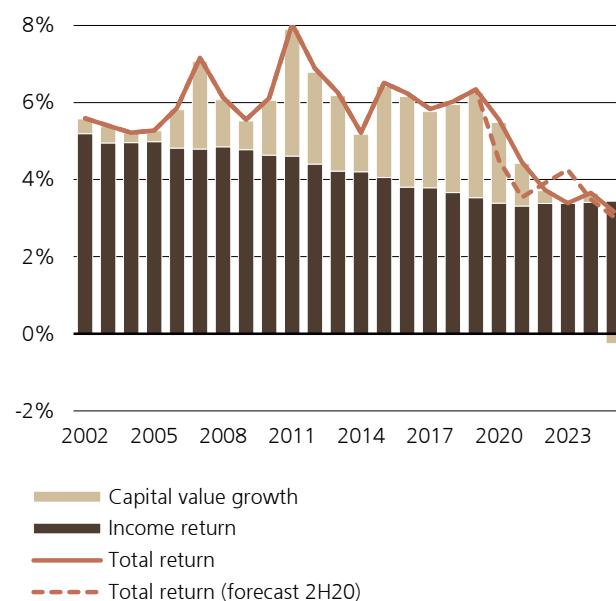
When looking at the details within this sector, we expect core office properties in CBD locations, as well as well-connected office hubs in secondary cities and agglomerations to show above-average resilience in term of both investment and occupier market fundamentals. Overall, we foresee an average total return of 3.1% per year for Swiss office property investments over the period of 2021-2023.

Retail assets likely to experience corrections

Aside from the direct stress caused by the extended shutdown periods for most non-food retail stores, the pandemic is likely to accelerate negative long-term trends which were already weighing on offline retailers way before the COVID-19 outbreak. Thus, the growing competition from e-retailers and the muted real wage dynamics are likely to persist in the near future, which calls for a cautious outlook on shop-based sales volume going forward.

These hostile conditions are weighing on the investment and occupier market fundamentals for retail assets. Therefore, we expect persisting downward pressure on the value of retail properties in the short-term and a modest total return of 2.8% per year over the period of 2021-2023. Assets with tenants active in resilient sectors such as food retail and properties located in prime locations are likely to outperform this average outlook.

Figure 7: Expected returns in the Swiss property market
(on the property level, mixed allocation, without leverage)



Source: MSCI / Wüest Partner; UBS Asset Management, Real Estate & Private Markets (REPM), February 2021. Note: Expected / past performance is no guarantee for future results.

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