

Real Estate Outlook

Switzerland – Edition 2H20



Business as (un)usual



Brice Hoffer
Head of Real Estate Research
& Strategy – DACH

The transaction market remains buoyant
as the risk premia of direct property
investments persist at an elevated level.



So far, the post-COVID-19 new normality appears to be nothing but business as usual in the Swiss real estate market. The continuing very low interest rate environment keeps driving investors towards rental property acquisitions, fueling transaction activity leading to further cap rate compression. Multifamily investments have become particularly favored due to their resilient nature in these very uncertain times.

Macroeconomics and investment market

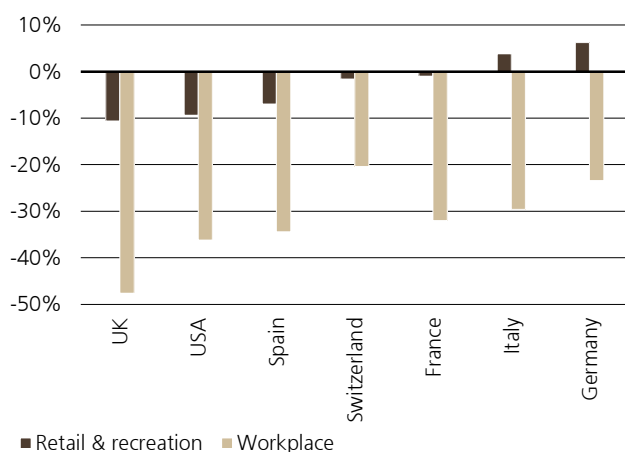
Data reveals the economic damage

While Swiss people and corporates are learning to cope with the so called "new normality", recent data is increasingly revealing the damage experienced by the economy at the peak of lockdown. According to first estimates, Swiss GDP contracted by -8.2% QoQ in real terms in 2Q20, when lockdown measures and mobility constraints deeply disrupted most of the economic sectors. Nevertheless, the Swiss economy has so far proven to be rather resilient from a relative perspective, as the eurozone experienced a real GDP correction of over 12% in 2Q20.

Rebound dependent on global pandemic management

Following the gradual lifting of lockdown measures, mobility started to peak up again, which has been supportive of broader economic activity. According to Google's mobility report during the week of the 31 August to 4 September, movements with a retail/recreational purpose approached pre-COVID-19 levels in most western countries (Figure 1).

Figure 1: Google's mobility report between 31 August and 4 September versus baseline level*



Source: Google Mobility Report; UBS Asset Management, Real Estate & Private Markets (REPM), September 2020
 Note: *Baseline – The baseline is the median value, for the corresponding day of the week, during the 5-week period 3 Jan-6 Feb 2020.

In the case of Switzerland, measured mobility is consistent with the rebound observed in consumption over the last three months, with a 3.4% YoY increase in nominal retail sales in July. By contrast, work commutes seem to persist at a subdued level compared to the baseline, indicating that home office activities are still widespread as corporates remain cautious about the virus's circulation. The gradual normalization of daily life activities compared to the paralysis experienced at the peak of the COVID-19 crisis in Spring, together with the fiscal support announced by the Swiss government (short-time work scheme, COVID-19 credits, etc.) are supportive of a marked

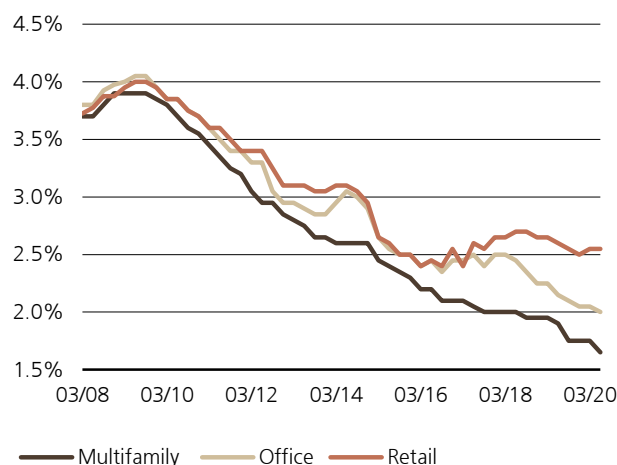
rebound in the Swiss economy in the second half of 2020 and beyond. According to current forecasts, real GDP is expected to grow by 3.8% in 2021, after retracting by -4.5% this year. Nevertheless, pronounced downward risks to this scenario persist. The recent increase of COVID-19 infection cases around Europe shows that the risk of further infection waves remains present. Furthermore, sectors relying heavily on international movements (tourism, air travel, etc.) are likely to need several quarters or even years to bounce back to pre-crisis levels of activity. In the end, the exact pace and path of economic recovery will depend largely on the effectiveness of the pandemic management, both in Switzerland and in other countries.

Transaction market remains buoyant

The macroeconomic environment continues to support deflationary forces. In July, the consumer price index (CPI) fell by 0.9% YoY. In addition, the persisting strength of the Swiss Franc is paving the way for the continuing low interest rate environment that Swiss investors have already been experiencing for more than five years. Therefore, Swiss government bonds remain in deep negative territory across all maturities, as the 30-year government bond posted a ca. -0.2% yield in last August.

In this low yield context and despite the uncertainty generated by the COVID-19 pandemic, the investment pressure for Swiss properties remains very elevated in the transaction market. After a slowdown experienced at the peak of the lockdown, transaction activity regained traction over the course of the last few months. Pricing remained quite aggressive in the prime multifamily and office markets, where net initial yields retreated by 25bps and 15bps YoY in the second quarter (Figure 2). At the same time, prime yields in the retail sector trended sideways, but growing difficulties in the occupier market are likely to lead to some outward yield movements in this sector in the coming quarters (see p. 6).

Figure 2: Prime net initial yields in the Swiss property market



Source: Wüest Partner 2Q20; UBS Asset Management, Real Estate & Private Markets (REPM), September 2020

Multifamily

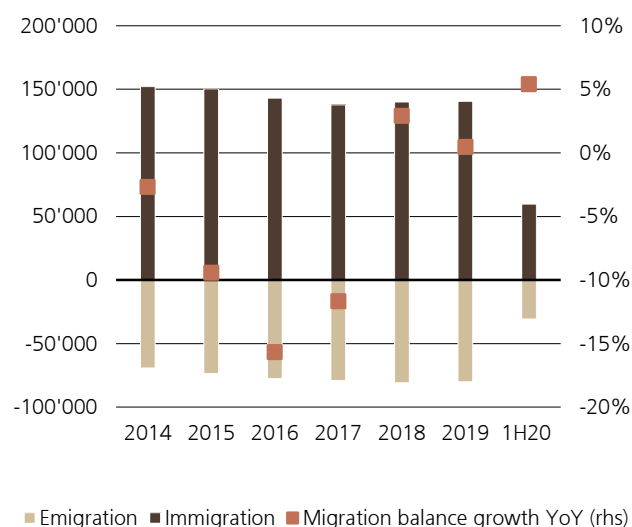
The foreseen resilience of the multifamily sector is becoming more apparent. While rent collection activities have so far remained immune to the effects of the pandemic, net migration dynamics proved to be surprisingly stable in the first half of the year. However, mobility constraints and pressure on wages are likely to weigh on demand growth in the coming quarters.

Absorption potential remains stable so far ...

The Swiss multifamily sector showed strong resilience in the first half of the year despite the pandemic outbreak. Compared to commercial sectors, impact on rent collections has so far been marginal and absorption potential remains surprisingly firm given the current uncertain conditions. The reason for this stability is explained by the deeper retreat of the emigration dynamics compared to the level of immigration. This led to a slight increase of 5% YoY in net migration compared to the first half of 2019 (Figure 3).

Figure 3: Net migration into Switzerland

(Number of persons)



Source: State Secretariat for Migration SEM; UBS Asset Management, Real Estate & Private Markets (REPM), September 2020

... but some slowdown is expected soon

Mobility restrictions and job market disruptions (see p. 6) are likely to weigh on the immigration dynamics in Switzerland in the coming months. In this context, demand growth in the Swiss multifamily market is likely to remain muted in the near future. Furthermore, the expected pressure on wages resulting from the deterioration of the employment situation will likely cause a drag on purchasing power of the Swiss population going forward. According to Bauinfo, the planning activity of new dwellings continues to trend slightly downward but persists at an elevated level in absolute terms with a yearly sum of ca. 44,000 units having received a building authorization at the end of 2Q20.

More pressure on asking rents, but less so on existing contracts

In light of current construction levels and the expected slowdown in demand growth, asking rents are likely to stay largely under pressure in the coming quarters, with the exception of highly demanded urban regions where market conditions remain very tight. However, in-place rents are likely to remain rather resilient, since rental level adjustments in existing portfolios are usually very gradual. According to Wüest Partner and MSCI, asking rents corrected on average by 1.4% p.a. between 2016 and 2019, while rental levels in institutional portfolios remained more or less stable (+0.1% p.a.).

Office

According to recent data, regional office market fundamentals have so far remained stable despite the consequences of the COVID-19 pandemic. Going forward, the effects of the ongoing job market disruption together with the postponement of corporate expansion plans are likely to weigh on the absorption potential in this sector, as well as on the level of asking rents.

Occupier market: So far, so good...

Fortunately, the COVID-19 shock occurred at a time when the Swiss office property market was showing increasing signs of strength. With the exception of the more imbalanced Geneva market, most Swiss urban centers were posting either decreasing offering rates or an office availability rate which oscillated at a very low level. Also, asking rents were bottoming out on average in the sector, while some central submarkets were even showing some early signs of rental growth.

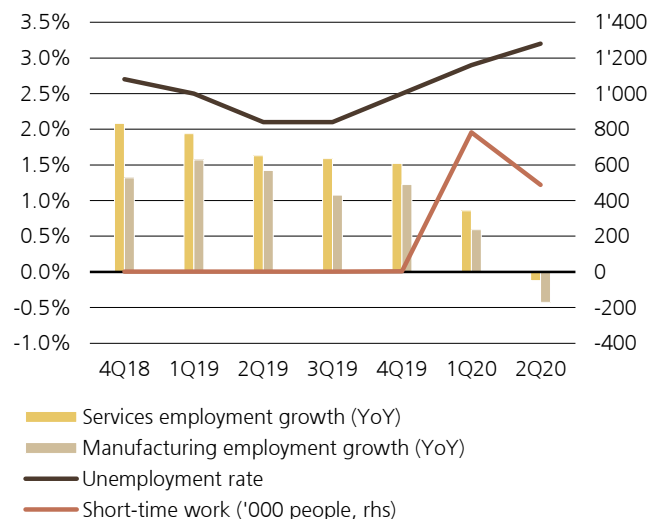
According to JLL, the occupier market is not yet showing clear signs of a COVID-19 related disruption. In the Zurich region, the number of available office spaces grew marginally between 1Q and 2Q20 (+3.9%), while the Geneva market experienced a limited retreat (-3.0%). As an additional testimony to the office market's resilience, Wüest Partner's data reported that asking rent dynamics remained firm in the same quarter, with a 0.7% QoQ increase on average in the Swiss market.

...but more disruptions expected

Despite some signs of robustness in the office occupier market, we do expect some more negative consequences from the pandemic going forward. The signals coming from the job market are indeed concerning (Figure 4). In the second quarter of this year, employment growth turned negative after 15 quarters of consecutive increases. Both the manufacturing (-0.4% YoY) and the service sectors (-0.1% YoY) were impacted, even if the latter has been resilient thus far. At the same time, unemployment rose modestly to a level of 3.2%, whilst the extremely elevated number of short-time workers (ca. 488,000) is likely to contribute to a further increase in

unemployment levels in a near future. Furthermore, companies will be eager to postpone expansion plans in the coming quarters given the actual level of insecurity. All these factors are likely to weigh on the absorption potential of office space and to weaken the stabilization trend of asking rents.

Figure 4: Sharp deterioration of job market conditions



Source: State Secretariat for Economic Affairs (SECO), Swiss Federal Statistical Office, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), September 2020

Office property market differentiation likely to increase

The consequences of the COVID-19 shock will probably affect the various office submarkets quite differently. Due to the strong recovery of this sector in the last quarters, market conditions in city centers and highly demanded business districts such as Zurich West are now very tight, indicating strong resilience in these locations going forward. By contrast, weak microlocations in the outer parts of local markets are likely to experience more pressure on absorption and rental levels in the coming quarters.

Retail

Following the easing of lockdown measures, consumption rebounded sharply in the Swiss retail market. However, trends undermining the weakening of the sector such as e-commerce and muted wage growth are likely to accelerate due to the consequences of the pandemic. In the transaction market, investors are expected to react to the deterioration of the rental prospects of retail properties.

Strong rebound in consumption post-lockdown

Following two months of apnea in the sector, physical retailers started to breathe again thanks to the gradual easing of lockdown measures. From May to July 2020, nominal sales increased on average by around 4% compared to the previous year, after having contracted by 20% YoY in the month of April. While food retail remained very resilient throughout

lockdown due to not being impacted by enforced store closures, several non-food sectors rebounded massively in the post-lockdown phase. Indeed, the statistics on household equipment, textiles, DIY and furniture reported a nominal sales volume increase of 16% YoY in last July.

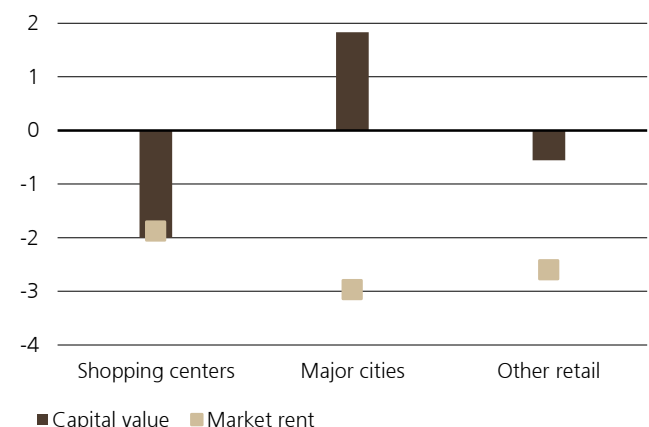
Adverse trends likely to get reinforced

Retail sales recovery is of course a very positive development for this industry as well as for the stability of the retail property market. Nevertheless, the lockdown measures were a harsh shock for an already fragile sector. Furthermore, recent trends that are undermining the weakening of the physical retail industry, such as e-commerce and real wage stagnation, are likely to get more traction due to the long-term consequences of the COVID-19 pandemic. All these adverse forces impacting retail tenants indicate a longer drag on the stability of the retail property market going forward.

Repricing of retail properties to be expected

As the perspectives for the retail occupier market look very gloomy, rental income prospects are likely to come under pressure in the coming quarters in most of this sector's submarkets, with the likely exception of assets with exposure to food and convenience retail. Property investors are expected to react to the worsening of the retail market fundamentals, leading to higher underwritten risk premia in transactions and subsequently to repricing in existing portfolios. According to MSCI/Wüest Partner, the shopping center sector has already started to correct itself by an average of -2% value growth p.a. during 2017-2019. By contrast, secondary retail locations have shown resilience so far and might undergo additional value adjustment in the near future. In the case of properties located in major Swiss cities, capital value growth has been firm over the past few years (+1.8% YoY in average). However, the collapse of long-haul tourism has mainly impacted high-street and luxury segments. Therefore, value evolution in this subsector will depend on the trade-off between short-term income deterioration and long-term location quality, which relies on investor judgment.

Figure 5: Average growth 2017-2019 by market segment (% p.a.)



Source: MSCI/Wüest Partner; UBS Asset Management, Real Estate & Private Markets (REPM), September 2020

Return forecasts

Overall, the Swiss real estate investment market is expected to remain robust in the coming quarters thanks to high exposure to the defensive multifamily sector and a persisting low interest rate environment. The evolution of the retail property market is likely to diverge from this general positive trend as value repricing is expected to occur in this sector.

Business as (un)usual

As mentioned on page 4, the elevated investment pressure amidst the persisting low interest rate environment is continuing to fuel the upswing of the transaction market for Swiss direct property investments. Rising transaction prices are leading to the compression of the net initial yield level, which in turns influences valuation discount rates towards the downside. In our opinion, the described investment pressure is set to continue at least in the short-run, despite the downward revision of the rental growth outlook due to the consequences of the COVID-19 pandemic. In this context, we expect an average performance of 4.0% p.a. over 2020-2022, with an average yearly capital value growth of 0.6% p.a. over this 3-year period in the direct Swiss property market.

Expected outperformance of the multifamily sector

The COVID-19 outbreak has increased the attractiveness of multifamily investments compared to most commercial sectors, as the defensive nature of rental dwellings is particularly interesting given the very uncertain times we are living in. In this context, we are witnessing high investor demand to increase exposure to this sector, which will likely continue to drive prices upwards in the transaction market in the near future. Capital value growth is expected to reach 1.7% p.a.

over 2020-2022, for an average yearly total return forecast of almost 4.9%.

Flat trend for office investments, but with upside risks

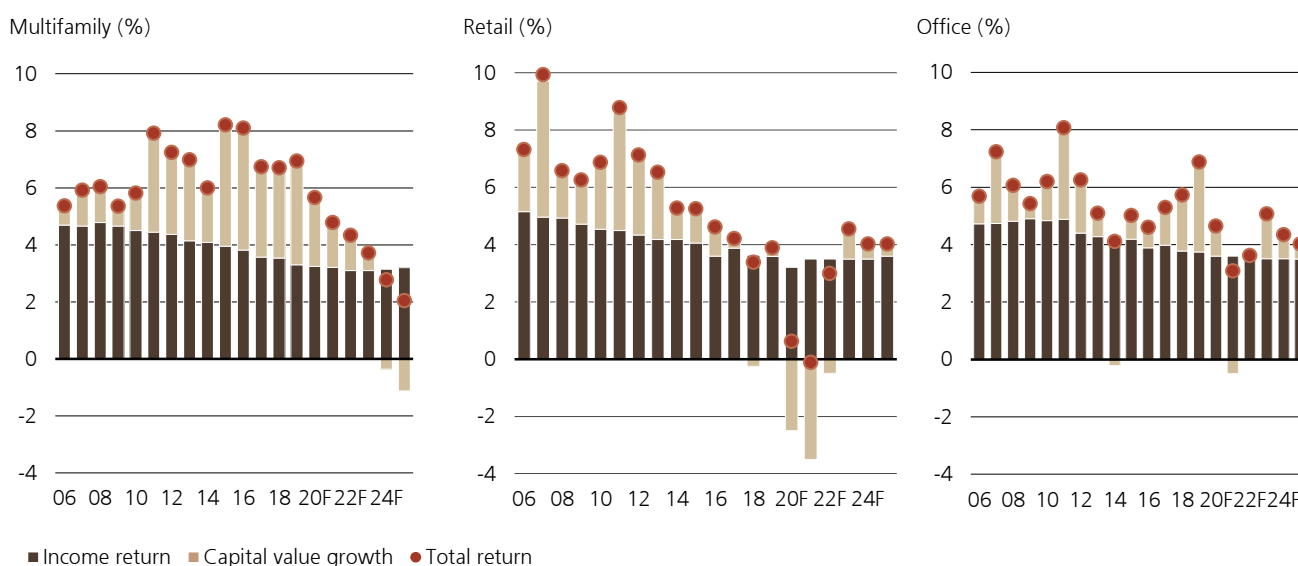
Given the expected weakness of future office space absorption and rental growth as a consequence of the ongoing economic disruption, we expect investor sentiment to become somewhat more cautious on the office sector. However, core office properties in high-quality locations are likely to remain highly sought after in the transaction market, while office spaces in less attractive locations could suffer some discounts on valuation, on a case by case basis. Overall, we expect office property values to trend sideways between 2020 and 2022, although upside risks related to the effects of the persisting low yield environment are expected to prevail. We expect total performance to reach 3.8% p.a. on average over the 3-year forecast period.

Value correction likely to occur in the retail property sector

The already gloomy outlook for the retail property sector deteriorated further due to the COVID-19 outbreak. Both the shock experienced during the lockdown and the consecutive acceleration of disruptive trends (e-commerce, stagnating real wages) are likely to lead to more pressure on rental income prospects in this sector. The foreseen retail property value correction is expected to amount to ca. -2% p.a. between 2020 and 2022 on average, as investors are expected to request higher risk premia when investing in this sector. As an exception, retail properties with tenants active in the food sector should remain generally unscathed by the repricing trend, while prime retail space in high quality locations could also show some resilience despite a negative rental income outlook.

Figure 6: Strong near-term outlook for multifamily investments

Expected returns in the Swiss real estate market (on the property level, unlevered)



Source: MSCI / Wüest Partner; UBS Asset Management, Real Estate & Private Markets (REPM), August 2020

Note: Expected / past performance is no guarantee for future results. The presented forecasts have been computed based on the assumption of a persisting low interest rate environment in the near future.

For more information, please contact:

UBS Asset Management

Real Estate & Private Markets (REPM)
Research & Strategy – DACH

Brice Hoffer
+41-44-234 91 56
brice.hoffer@ubs.com



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