

Real Estate Outlook

Switzerland – Edition 1H22



Constant change



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Investor demand for Swiss property remains strong despite the uncertain macroeconomic environment.



We expect the future increase of the Swiss interest rate environment to be gradual. In this macroeconomic environment, Swiss property investments are likely to remain an attractive alternative to a still low yielding bond market.

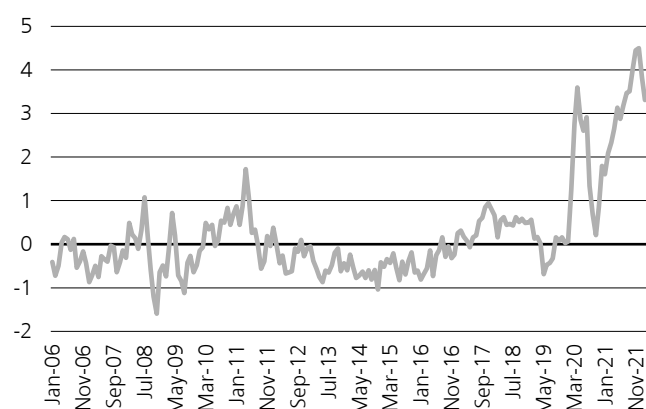
Macroeconomics

Interest rates likely to persist at a modest level

War in Ukraine forms an eclipse over the pandemic

The global macroeconomic environment has witnessed many surprises over the last few months. First, the outbreak of the Omicron variant of COVID-19 led to a re-introduction of restriction measures in most developed economies during the winter period. Overall, the economic impact of this shock was quite limited in comparison to the lockdown phases which weighed on European economies a year ago. In the case of Switzerland, economic recovery slowed down to +0.3% QoQ in 4Q21, with most of the negative effects focused on a few sectors such as the travel industry and gastronomy. Nevertheless, the restrictions together with some longer-lasting issues from the pandemic outbreak continued to disturb international supply chains (see Figure 1).

Figure 1: Global Supply Chain Pressure Index (GSCPI)



Source: New York Fed; UBS Asset Management, Real Estate & Private Markets (REPM), March 2022

A positive side-effect of the Omicron wave is the expected gradual move towards an *endemic* to pave the way for a sustainable exit out of the long-lasting health crisis. The lifting of most pandemic-related restrictions last February in Switzerland is a strong evidence of this trend. It also indicates a continuation of the economic recovery in Switzerland in 2022. However, the recent Russian invasion of Ukraine caused an eclipse on the progress made from the pandemic and led to some downside risks for the macroeconomic outlook for 2022 and beyond.

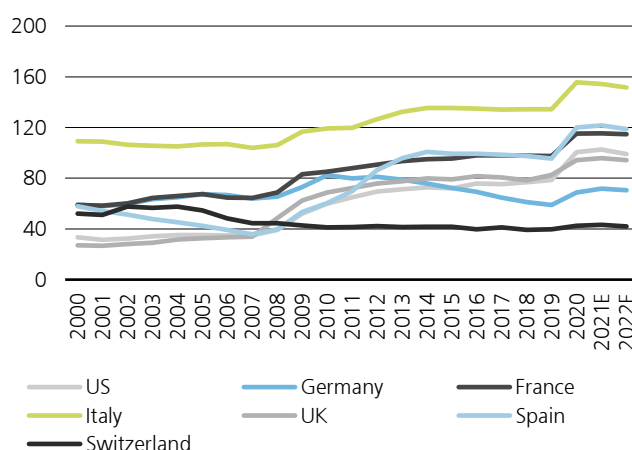
Energy to impact future inflation dynamic

As of now, the Swiss economic growth outlook remains strong for the coming quarters despite the outbreak of the war in Ukraine. According to current forecast from Oxford Economics, real GDP is still expected to increase by 2.6% in 2022. So far, the greatest impact of the war in Ukraine is expected to be felt in the form of additional price increases worldwide. Indeed, Russia is a major fuel provider, especially for European economies, and an important producer of cereals together with Ukraine. Keeping this mind, the elevated inflation trend observed globally is likely to become more acute and last longer than initially anticipated.

Swiss interest rate increase likely to be gradual

The boost in inflation is likely to be driven by increasing energy and commodity prices, which typically weigh on the intensity of future economic growth. Therefore, global central banks, and in particular the European Central Bank, are likely to follow a very gradual path towards the normalization of the interest rate environment to avoid the risk of a simultaneous subdued economic growth and an elevated inflation dynamic (so called *stagflation*). In Switzerland, the strength of the Swiss franc is likely to help contain the inflation dynamic by weighing on the level of import prices. We expect the currency to remain strong, not only due to the country's safe haven attributes, but also other macroeconomic aspects such as the sound financial positioning of the Swiss public sector both in absolute and relative terms (see Figure 2). Thus, we do not expect the Swiss National Bank to exit the negative interest rate policy in the coming quarters. This still advocates for a modest yield level on the Swiss bond market going forward.

Figure 2: Gross public debt (% share of GDP)



Source: UBS Investment Bank; UBS Asset Management, Real Estate & Private Markets (REPM), March 2022

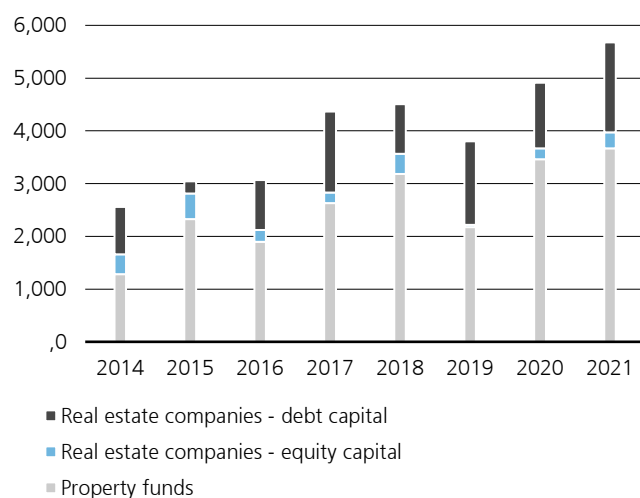
Investment market

Transaction market to remain very competitive

Investment pressure in the property market remains strong

Recent data is showing that investor interest for Swiss real estate is still high. According to the partial census from JLL Switzerland, over CHF 4.6bn of commercial real estate transactions have been concluded last year. Also, Safra Sarasin reported that 2021 has been a record year for capital market transactions to the benefit of listed Swiss real estate investment structures (see Figure 3). In total, over CHF 5.6bn of debt and equity capital have been raised in the sector over the course of last year. As a result, we expect transaction market environment for direct property investment to remain very competitive over the coming months. In fact, large fund raising volume has not yet been deployed in the direct market.

Figure 3: Capital market transactions in the listed Swiss real estate sector (CHF million)



Source: Safra Sarasin; UBS Asset Management, Real Estate & Private Markets (REPM), March 2022

Transaction yields on a downward trend in all sectors

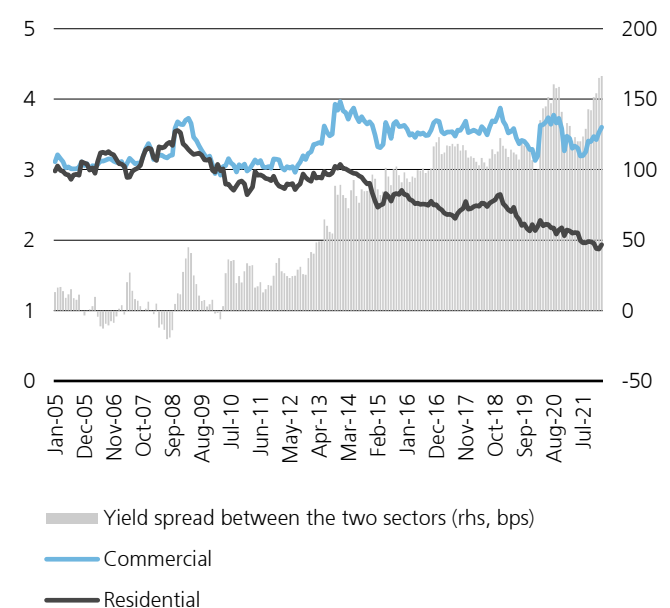
Strong investor interest continues to materialize in increasing transaction prices and retreating transaction yields. According to Wüest Partner, initial transaction yields compressed by an average of 11 bps in the prime segment of the Swiss property market over the second half of 2021. The prime residential and retail sectors saw an initial yield retreat corresponding more or less to the market average (-10 bps), while prime office assets experienced an above-average compression of 15 bps. With this in mind, the investor community seems to price in a scenario where good office assets will still experience a dynamic occupier demand in the post-pandemic job market – a view that we share (see more on page 6).

Divergence between dividend yield levels of residential and commercial real estate products

The strong investor interest for the Swiss real estate sector can also be observed in the listed real estate fund market (see Figure 4). At the end of February 2022, the average agio still amounted to 34% of net asset value (NAV) in the sector, despite the elevated uncertainty triggered by the war in Ukraine.

In terms of sectoral trends, residential products remained more sought after than their commercial counterparts over the last months. The resilience of residential income during the pandemic and the emotional shock triggered by the Omicron wave likely explains this evolution. This demand trend aggravated the divergence already observed for many years between the levels of dividend yield offered by the two sectors. Since 2013, the dividend yield of residential funds tended to compress at a steady pace to a level below 2% on average at the beginning of 2022. At the same time, the dividend yield in the commercial sector fluctuated between 3 and 4% on average. This led to an increasing dividend yield gap between the two sectors, which amounted to almost 170 bps at the end of February 2022.

Figure 4: Dividend yield of listed Swiss property funds (%)



Source: Refinitiv February 2022; UBS Asset Management, Real Estate & Private Markets (REPM), March 2022.

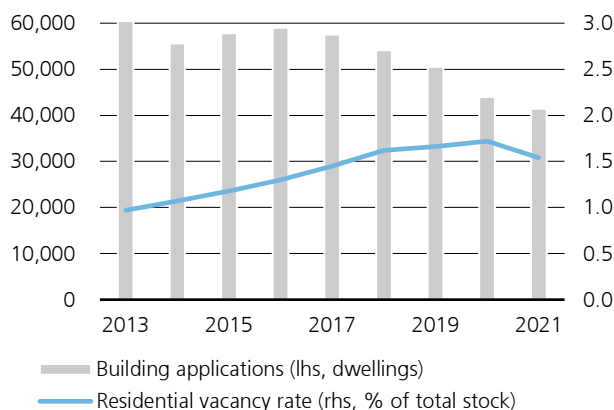
Occupier market

Growing diversity of the commercial sectors

Multifamily: market fundamentals bottoming out

The stabilization trend continues on the occupier market for Swiss rental housing properties. According to Bauinfo, planning activity for new residential units continued to slow down in the second half of last year. The annual volume of building applications amounted to 41,500 dwellings in 2021, which was almost 6% below the volume reported in 2020. At the same time, migration continued to show signs of strength despite the uncertainty related to the pandemic. Net migration into Switzerland amounted to over 61,000 people in 2021. We anticipate a further compression of the average vacancy rate in the market throughout the course of 2022, after a first retreat was observed in 2021 (see Figure 5). Also, offering rents are likely to bottom out in most local markets in the coming quarters, which paves the way for broad-based rental growth in the sector going forward.

Figure 5: Planning activity and vacancy rate in the Swiss housing market



Source: Bauinfo 4Q21, Swiss Statistical Office; UBS Asset Management, Real Estate & Private Markets (REPM); March 2022

Offices: strong assets to be the winners of the pandemic

The pandemic-related uncertainty as well as the delivery of numerous office building projects led to a further increase of vacancies in the Swiss office property market in the second half of 2021. According to JLL, the average availability rate increased from 4.3 to 4.7% in the course of last year in the major markets of the country. However, on a micro-level, market fundamentals are showing marked differences between central office locations and fringe areas. Indeed, both investor and occupier demand remain strong for high-grade office properties in core city locations, while peripheral assets are starting to suffer in the current market conditions.

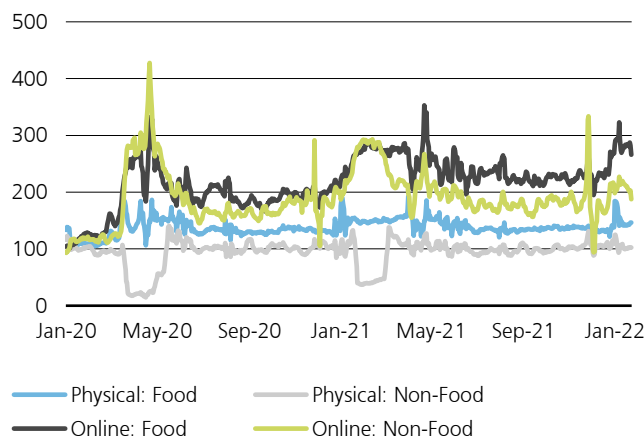
This supports the scenario of a dynamic office demand for modern assets in established business locations going forward, while low-grade quality office buildings in secondary districts risk becoming obsolete in the post-COVID-19 market environment.

Retail properties: mixed outlook for the sector

According to data from Monitoring Consumption Switzerland, the negative impact of the Omicron wave on revenues for Swiss offline retailers remained contained (see Figure 6). Naturally, part of the growth related to the Christmas season and New Year's Eve shopping has been absorbed by e-commerce. However, physical stores showed a resilient picture compared to previous waves of COVID-19. The recent lifting of most pandemic related restrictions should pave the way for a sustainable recovery of offline retailer activities in 2022.

However, the mid- to longer-term outlook remains muted for the sector, as we anticipate the long-lasting development of e-commerce to continue to weigh on offline retailers going forward. Nevertheless, several subsectors of the retail property market are likely to evolve positively despite this top-down headwind. As an example, this is the case for food retail properties which are modestly impacted by the competition of e-commerce, as well as assets in sought-after retail locations. According to data from Wüest Partner, offering rents for prime retail properties experienced a very positive evolution in the markets of Zurich and Geneva in 2021, with a 13% and 8% increase YoY, respectively.

Figure 6: Retail sales volume (index from mobile and card payments, 7-day moving average, 100 = value same day 2019)



Source: Monitoring Consumption Switzerland; UBS Asset Management, Real Estate & Private Markets (REPM), March 2022

Return forecasts

Performance expectations remain robust

Overall return outlook widely unchanged

Recent developments in the occupier and investment markets did not trigger a major revision of our total return forecast for a balanced exposure to direct Swiss property investments compared to [our last paper](#) published in September 2021. In a 3-year outlook for 2022-2024, we still expect a 4.0% total return on average p.a. on a property level (i.e. without any leverage and fund structure cost). As the interest rate environment gradually increases, we expect this to weigh on capital value growth at the edge of the 5-year forecast horizon. In addition, we expect robust income returns to become the main driver of future real estate investment performance in the longer-term.

Multifamily as a near-term outperformer

Investor demand persists at an elevated level for multifamily assets in Switzerland. This trend continues to drive a compression of the initial yields in the sector. This generally leads to a significant gap between the level of the discount factors applied for standing asset valuations and the lower returns observed on the transaction market. Therefore, we expect more capital value growth for the residential sector in the near term, driven by some compression of the discount factors in property valuations. We expect this to lead to an outperformance of the residential sector over the next few years, with an expected total return of 4.4% p.a. on average

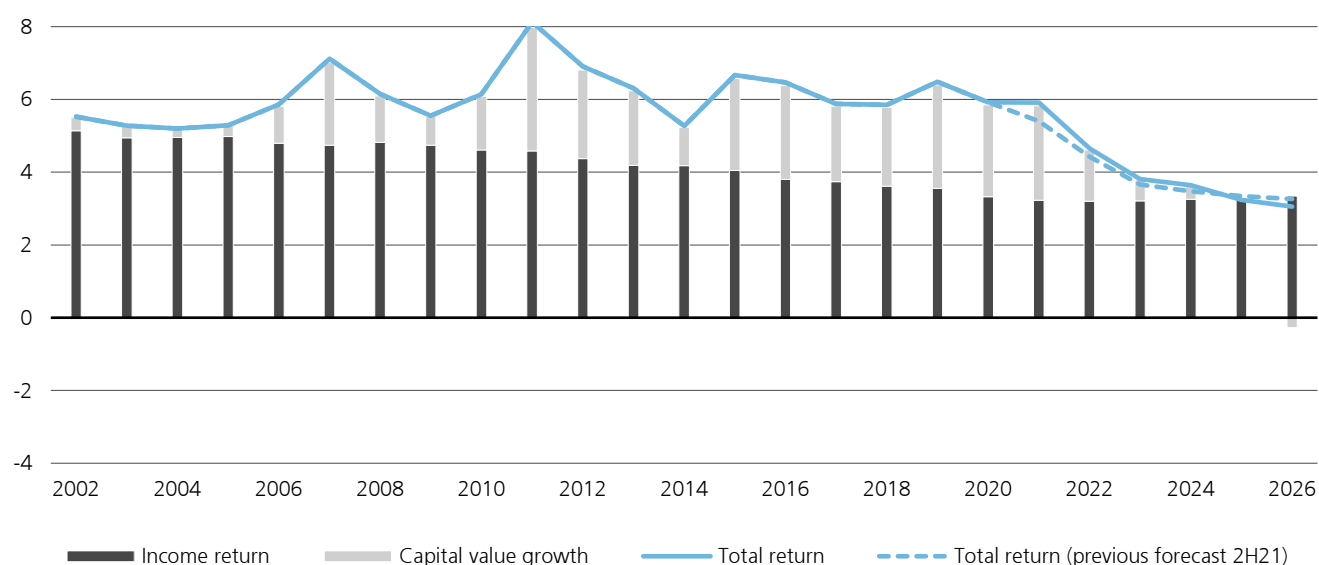
over 2022-2024. Also, the forecasts may face some upside risks depending on the level of rental growth that will materialize in the sector over the coming years (see rationale on page 6).

Commercial property investments: single assets will likely diverge from the sector average

Overall, we expect exposure to the Swiss office sector to return 3.6% p.a. of total performance over 2022-2024. However, the performance of single office assets is likely to vary widely around the sector average. As mentioned on page 6, we expect modern office assets in strong business locations to perform fairly well in the coming years, while significant value corrections are likely to occur in fringe locations and for older office schemes.

The return outlook for Swiss retail properties shares some similarities with our view of the office sector. On average, the sector is expected to underperform over the next 3 years, with a 3.7% total return expectation p.a. over 2022-2024. However, several subsectors of the retail property market are likely to beat this sector's average due to strong investor and occupier demand, such as stores with a focus on food and convenience shopping, as well as assets in prime retail locations (see rationale on p.6).

Figure 7: Expected returns for mixed property exposure in the Swiss market (% p.a., property level, unlevered)



Source: MSCI / Wüest Partner; UBS Asset Management, Real Estate & Private Markets (REPM), February 2022
Note: Expected / past performance is not a guarantee for future results.

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