

Real Estate Outlook

Switzerland – Special COVID-19 Edition



In these uncertain times...



In today's uncertain environment,
selectivity has become more
important than ever.

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The outbreak of the COVID-19 pandemic has disrupted the economic outlook abruptly. Switzerland is set to experience a sharp GDP contraction in 2020, although economic activity is slowly recovering thanks to the progressive lifting of the soft lockdown measures. This situation supports a continued extreme low interest rate environment, which contributes to the attractiveness of Swiss real estate investments.

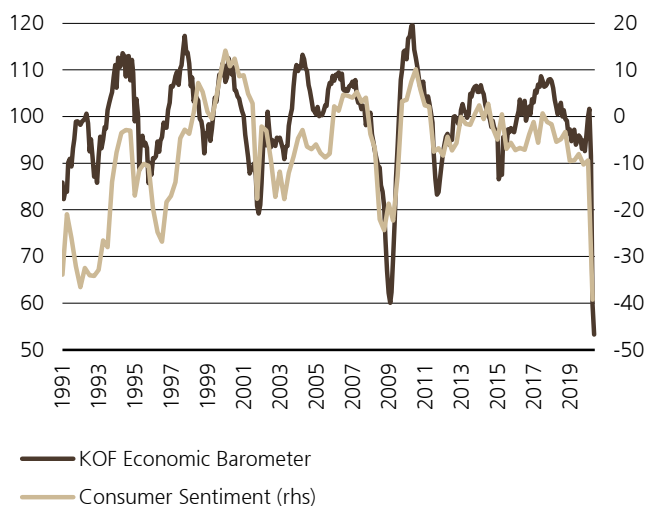
Macroeconomics and investment market

Swiss economy entered in recession

Just a few months ago, 2020 was still expected to be a year of modest but positive growth for the Swiss economy. However, the outbreak of the global COVID-19 pandemic led to an abrupt and dramatic downward revision of the economic outlook. The introduction of lockdown measures of various intensities to contain the propagation of the coronavirus has been challenging economic stakeholders globally. The forced closure of non-essential stores and restaurants, the collapse of tourism activities and the disruption of global supply chains are some prominent examples of this severe stress.

In response to the COVID-19 shock, sentiment in the Swiss economy has deteriorated dramatically. Last May, the KOF economic barometer dropped to a value not reported since the Global Financial Crisis (53.2 points), and the consumer sentiment indicator reached an historically low level of -39.3 points in April (see Figure 1). In this context, the question is not whether the Swiss economy will experience a recession in 2020, but how severe the decline will be. Currently, the range of forecasts remains wide in our industry, but the consensus points towards a sharp correction of real GDP of over -3%.

Figure 1: Leading economic indicators retreated sharply



Source: Swiss Economic Institute (KOF), State Secretariat for Economic Affairs (SECO); UBS Asset Management, Real Estate & Private Markets (REPM), Research & Strategy

Recovery path set to be very gradual

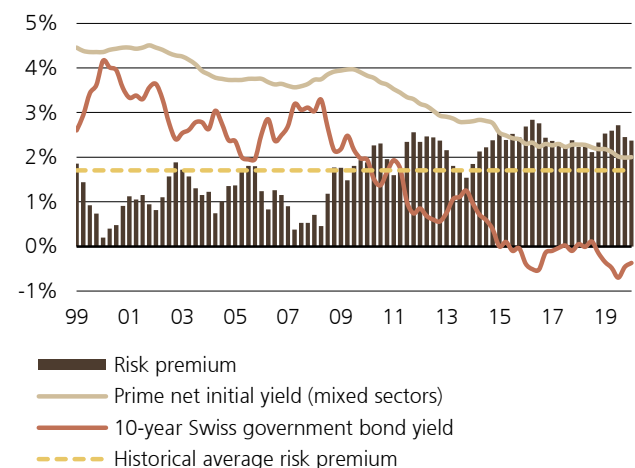
The progressive lifting of the lockdown measures, which gained traction in Switzerland over the course of May, constitutes a positive development for the recovery of the economic activity both locally and abroad. However, this recovery process is set to be very gradual. First, increased hygiene requirements and social distancing measures remain in place, weighing on the activities in many sectors, both from an income and cost point of view. Furthermore, international travel movements are likely to remain constrained in the near future, with severe consequences for the sectors concerned. For instance, Fitch Ratings expects that occupancy rates in the European hotel market will drop by 60% in 2020, and that a full recovery is not to be expected before 2023 at the earliest. Finally, global supply chains will require some time to return to a normal regime, which might limit the level of activity in certain manufacturing industries.

Prolongation of the ultra-low interest rate environment

The elevated level of uncertainties continues to support the strength of the Swiss Franc. The strong CHF together with the ongoing economic downturn and recent collapse of oil prices are weighing on the inflation outlook. The Swiss macroeconomic environment is likely to be even slightly deflationary in 2020 and 2021, with a forecasted average inflation rate of -1.0% and -0.5% respectively.

The current macroeconomic outlook is supportive of the continuation of the negative interest rates policy of the Swiss National Bank, which paves the way for a prolongation of the ultra-low yield environment. Of course, during the outbreak phase of the pandemic, the 10-year Swiss government bond yield moved significantly upward. This repricing has been triggered by acute liquidity needs of certain market participants and an elevated level of uncertainty. In the meanwhile, the trend has reversed and this bond yield oscillated around the value of -0.4% at the end of May.

Figure 2: Attractiveness of direct property investments remains elevated



Source: Wüest Partner 1Q20, Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), Research & Strategy

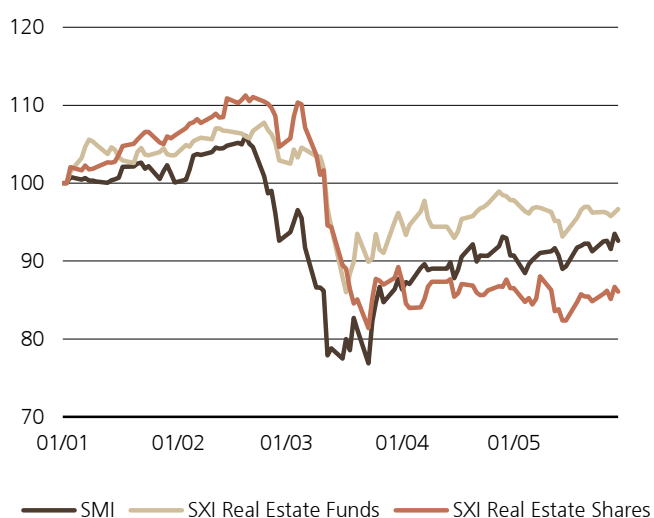
The persisting ultra-low yield environment continues to support the attractiveness of direct property investments in Switzerland. Despite the temporary spike of bond yields and increasing entry prices, the average risk premium in the prime property market amounted to 2.4% at the end of 1Q20, ie. about 70 basis points above the historical average (see Figure 2). Due to this elevated yield level in relative terms, the transaction market for direct property investments has remained quite active over the past few months, even if the COVID-19 pandemic has complicated the activities of market participants.

Listed market: Resilience of property fund prices

In the listed real estate fund market, investor interest remains quite vibrant as well. The large volume of announced capital market transactions (capital increases, new vehicle listings) and the relative resilience of property fund prices are highlighting this confidence, especially in the case of residential products. The price index of the overall Swiss property fund market (SXI RE Funds) posted a slight negative performance of -3.3% year-to-date when measured on 1 June, whilst the price of the broad equity market (SMI) corrected by -7.4% (see Figure 3).

Regarding listed Swiss real estate companies, investor sentiment seems to remain more cautious so far (see Figure 3, SXI RE Shares). The contrast with the resilience of the listed funds can be explained by various factors. In particular, many listed real estate companies are rather focused on commercial sectors, which are more likely to be impacted by the consequences of the COVID-19 pandemic than the multifamily market (see next sections). Furthermore, the investor base of the listed real estate companies tends to be more international and focused on active strategies than in the case of the listed funds, which speaks for a higher price volatility. This effect is amplified by the greater liquidity of the real estate equities.

Figure 3: Listed real estate and stock market price indices
(100 = 1/1/2020)



Source: Refinitiv; UBS Asset Management, Real Estate & Private Markets (REPM), Research & Strategy

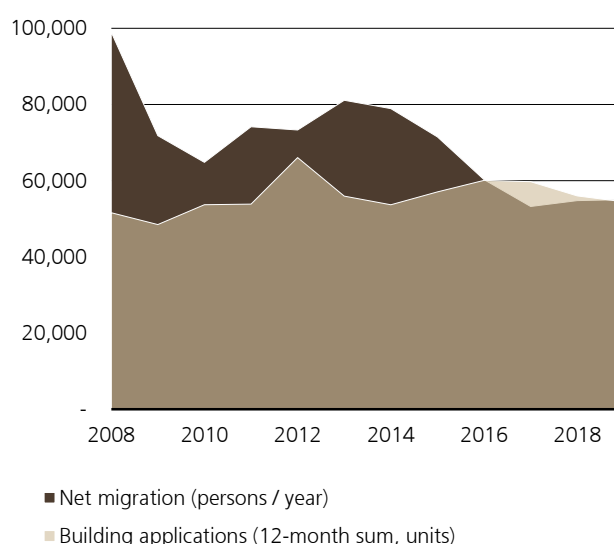
Multifamily

Rental dwellings unscathed by the soft lockdown

By contrast to commercial properties, the multifamily sector remains so far quite immune to the effects of COVID-19. At the peak of the soft lockdown, residential properties became the shelter of most daily activities and the rent collection process remained widely undisrupted in the multifamily sector during this extraordinary situation.

However, in the near term, the global pandemic is likely to lead to an increase of the supply/demand-imbalance in the Swiss multifamily market. The deterioration of the economic outlook as well as health-related concerns are likely to weigh on the immigration dynamics in 2020. The latter was already stagnating at a moderate level before the outbreak of the crisis, with a total net migration of ca. 55,000 people in 2019 (see Figure 4). On the supply side, the planning activity of new dwellings has also started to decelerate in the last few quarters, whilst soft lockdown measures as well as the supply chain disruption for some construction materials have led to the postponement of several residential projects. Nevertheless, the expected reduction in the absorption potential is likely to be more pronounced than the decline of construction activity.

Figure 4: Residential construction and migration dynamics 2008 - 2019



Source: State Secretariat for Migration (SEM), Wüest Partner; UBS Asset Management, Real Estate & Private Markets (REPM), Research & Strategy

The persisting imbalance in the multifamily market is likely to continue to weigh on rental growth prospects in the coming quarters. As in the recent past, these effects should remain limited in the urban centers and the core of their agglomerations, as market conditions are still very tight in those areas.

By contrast, the deterioration of the market fundamentals should accelerate in more peripheral regions, where the absorption potential is limited. Overall, we expect pricing to remain firm in the near future for two reasons, first, as professional investors have recently tended to be rather cautious in underwriting future rental growth in the Swiss residential market, and secondly, as the expected resilience of multifamily properties is likely to support the attractiveness of this sector.

Post-COVID-19: Integrated office usage as a must?

Amidst the COVID-19-pandemic, many corporates have required their office employees to work from home for a prolonged period of time in order to comply with social distancing measures. This long and forced home office experience raises some key questions – will the trend of working from home persist after the end of this exceptional situation and what effects might this have on the structure of the property market?

Focusing on the multifamily sector and assuming that office usage will need to be increasingly integrated in residential buildings, we can imagine two potential models for this evolution. The first one would lead to an increasing need for at least one additional room in apartments, where home office activities can be completed comfortably. Readers who had to work from the kitchen table for months are likely to be in agreement with this proposal. The other option, which is probably more efficient economically for the tenant, would be to integrate some shared office space into the residential building that can be booked on demand by the users.

In both approaches, the deeper integration of office usage into multifamily complexes would likely lead to increased costs for the tenants concerned. Employer participation in these costs might be necessary in order to implement this work model, at least for permanent home office workers. A decision of the Swiss Federal Court in 2019 on a litigation between a firm and an employee was supportive of such compensation.

Office

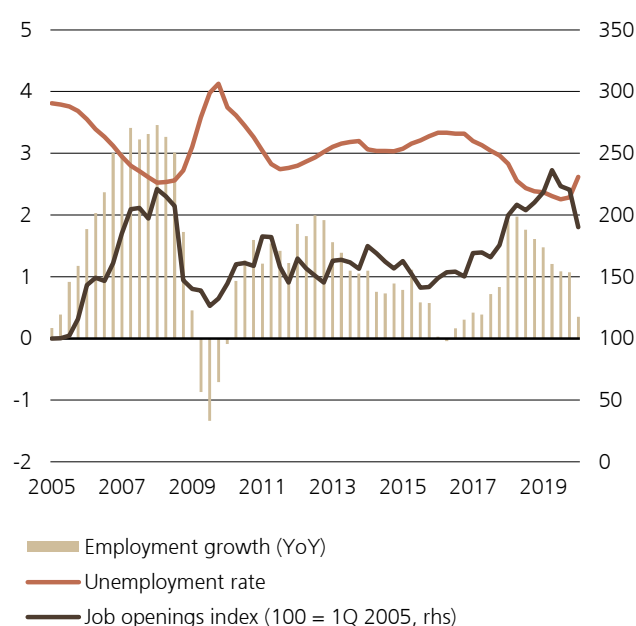
Stabilization of market fundamentals comes to an end

2019 has been a very positive year for the evolution of the office market fundamentals in Switzerland. The very robust situation in the job market supported the absorption of office space, in particular in the Zurich region, which led to a decrease of available offices. As a result, offering rents bottomed out in most of the main regional markets after having shown a downward trend for several years. The abrupt deterioration of the economic outlook due to the outbreak of COVID-19 is likely to disrupt the ongoing stabilization of the office market fundamentals.

Recent data highlights the first signs of this disruption in the job market. In 1Q20, where the extent of pandemic-related damages was still limited, employment grew by only 0.3% YoY, ie. the weakest dynamics in more than three years (see Figure 5). Furthermore, the number of job openings decreased in the same quarter by 13% YoY, and the unemployment rate climbed to 3.3% in April.

The deterioration of the job market fundamentals is likely to indicate a postponement of corporate expansion plans, as well as an increasing likelihood of firm bankruptcy. All these factors will weigh on the absorption in the office market in the near term and on future rental growth prospects, especially given the rather elevated number of new office projects to be delivered in the coming quarters. In this context, offering rents are likely to come under pressure again and the market value of some office assets might experience some moderate corrections, in particular in secondary locations and in properties with a weak tenant structure.

Figure 5: Last data signaling a job market deterioration (%)



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

Post-COVID-19: A profound disruption of the office sector?

As working from home became a widespread practice in the time of the soft lockdown, the thesis of a persisting home office trend after the end of the pandemic has recently gained a lot of attention in the market. Such an evolution would weigh dramatically on the demand for office space, which would lead to a profound structural transformation of this sector, similar to the one experienced by the retail industry due to the emergence of e-commerce.

At this early stage, it is very difficult to validate or challenge such a disrupting view. Following the tragedy of the World Trade Center in 2001, a popular thesis advocated that this exceptional event would trigger the death of high-rise office buildings since corporates might become reluctant to work in this kind of space going forward. This view did not materialize. Nevertheless, it seems very likely that the forced home office experience will lead to many employees in future seeking to work from home regularly.

This scenario suggests that the number of required workplaces would come under growing pressure. But it does not mean that the total absorption potential of office space would necessarily drop, since common areas and meeting facilities are gaining importance in smart working concepts. Like the layout of office space, office market geography might get revamped as well by such a trend.

Whilst city centers are likely to keep their prominence as an essential corporate show-room, locations well-connected with public transport in densely populated agglomerations might increasingly become the sites of business centers, where office employees residing in the area can conduct their work on a discretionary basis rather than commuting constantly to the office headquarters. This applies as well for secondary cities enjoying high accessibility. In the end, the long-term effects of the pandemic, in our view, are more likely to disrupt the structure of future office demand rather than its intensity.

Retail

Harsh stress test for a fragile sector

The challenge posed by COVID-19 to the retail sector is huge. With the exception of stores selling food and further essential goods, all shopping, catering and personal care service amenities were forced to close for almost two months after soft lockdown measures were introduced. Despite the exceptional financial support of the Confederation and the gradual recovery of activity, this unprecedented time has been a harsh stress test for an already weakened sector. The growing trend of e-commerce, the stagnation of real wages and the existence of shopping tourism activities in border regions have challenged the Swiss retail industry for several years. Moreover, even resilient high-street locations are now heavily disrupted by the collapse of international tourism.

The COVID-19 shock is likely to lead to an acceleration of the structural change, which was already happening in retail before the outbreak of the pandemic. In particular, market rents are expected to face more pressure, after having corrected by 2.3% in 2019 according to MSCI / Wüest Partner, and the likelihood of rent loss is expected to pick up significantly.

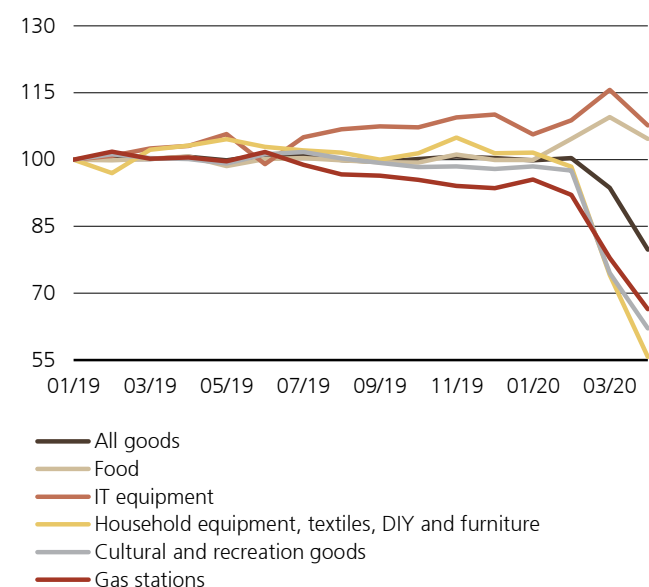
Due to these pronounced challenges in the occupier market, investors are likely to ask for a higher risk premium when considering an asset with a retail exposure. This might lead to a market value repricing, in particular in the case of properties situated at secondary locations.

Post-COVID-19: Food-retail as a safe haven?

Despite the profound disruption of the retail industry, the pandemic has highlighted the persisting resilience of one of its sub-sector: the food market. As food stores have been unscathed by the measures of the soft lockdown and mass panic buying brought an additional boost to their sales volume, the sector's revenues have evolved very positively since the beginning of the year. Last April, the nominal sales of food retailers increased by 3.9% YoY, whilst revenues were down by 20.7% YoY in the whole retail industry (see Figure 6). At the same time, other retail sectors that were already under pressure before the pandemic, such as fashion, household equipment and bookstores, all posted sharp corrections of their sales numbers due to the effect of the soft lockdown.

The limited impact of e-retailers in the food market, with 2.8% market share in 2019 according to GfK, is also supportive of the long-term prospects of physical food retailers and convenience shopping, especially for stores working with fresh products. Compared to non-food goods, where almost 17% of all sales were conducted online in 2019 with a persisting growth trend, the food sector seems likely to remain a safe haven in a more and more challenging retail industry.

Figure 6: Nominal retail sales indices by sector
(January 2019 = 100)



Source: Swiss Federal Statistical Office; UBS Asset Management, Real Estate & Private Markets (REPM), Research & Strategy

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