Coronavirus

How the pandemic may impact the real estate market

Switzerland will most likely have to accept a recession to slow down the spread of the coronavirus. The real estate market is also likely to feel the impact of this, as demand for space comes under pressure in a recession. The effects that can be expected will depend on how long the pandemic affects the Swiss economy. The consequences this will have for the occupier and investment markets vary greatly across all real estate sectors.

Wüest Partner, 19 March 2020

Background

- Social life and the economy are severely restricted by the recent orders issued by the authorities in the wake of the coronavirus pandemic. From the current perspective, the economy is likely to slide into recession. A temporary increase in unemployment is therefore also to be expected, especially in those economic sectors that have been effectively brought to a standstill by the current measures. This will have consequences for the Swiss construction and real estate markets that differ from sector to sector; however, based on the information currently available, it must be assumed that the markets will be temporarily impaired, affecting all sectors.
- The duration of the pandemic and the restrictions imposed by the authorities will largely determine the extent to which the Swiss construction and real estate markets will be affected. The markets can certainly cope with short-term economic downturns, as recent history shows. Wüest Partner assumes that the restrictions will last for several months and that a recovery will happen in the second half of 2020. More negative or positive scenarios are also conceivable; however, these are not the subject of the comments in the present assessment.
- The current coronavirus crisis is affecting the Swiss economy at a time when it is in relatively good shape. The increase in gross domestic product last year was 0.9 percent (inflation adjusted). This means that we can look back on a whole decade of steady economic growth. In parallel, employment has grown by an average of 1.0 percent per year during this period. In January 2020, unemployment was at a low 2.3 percent of the labour force. The growth of the last decade was coupled with wage increases at low inflation, which contributed to a 31 percent increase in net assets per capita (between 2009 and 2018). In addition, the federal government and many cantons have been able to generate budget surpluses in recent years.

The following points will discuss possible consequences for the real estate market. Estimates of the investment and construction market are followed by an analysis of the commercial, residential and owner-occupied markets. Finally, we address a number of aspects that could become longer-term trends as a result of the current situation.

Real Estate Investments

Decreasing transaction volume

It is assumed that the transaction volume of investment properties will decline as a result of the current situation. It is correspondingly challenging to predict the change in yield expectations and willingness to pay to be determined exactly.
In many sub-sectors, rental potential is expected to be limited in the meantime, but will rise again in the medium or longer term. As far as yield expectations are concerned, differing influences can be observed, which is why little movement is likely in this regard for the time being: Although higher risks are apparent, yields on government bonds remain at a low level.

Potential for further interest rate cuts

With the coronavirus pandemic, the prospect of even lower interest rates has become more established. Some central banks, such as those in the United States and the United Kingdom, have already lowered their key rates.
In the first two months of 2020 (after the outbreak of the virus), yields on government bonds fell in many countries. The recent countervailing increases in yields are due, among other things, to the enormous uncertainties in the capital markets, to the adjustments that have become necessary in investment portfolios and to the increased liquidity requirements of individual investors. In the medium term, however, yields on government bonds in Switzerland are likely to remain at a very low level.

Real estate investments remain attractive

Real estate investments are relatively attractive not only because of the low interest rates, but also because rental income is a more secure source of income than the income of traditional companies. If the Swiss franc continues to appreciate in its function as a safe haven, the prospects for real estate owners are somewhat better compared to investors of other opportunities in Switzerland, as real estate owners generate their income in Swiss francs.

Value adjustments: sectors react differently

A sharp drop in the value of real estate investments is not to be expected. In principle, real estate values fluctuate less than the values of other asset classes. For this reason, and also because of the long-term perspective of many investors, a wave of sales is also not expected.
However, the market values of commercial properties in secondary locations, hotels, special-purpose properties and large non-food retail properties, could come under greater pressure. Based on the information currently available, smaller corrections to the market values of residential properties are to be expected.

Yields on 10-year government bonds
(as of 17 March 2020)

Source: Tradingeconomics.com

In principle, core properties with stable cash flows should be less exposed to current developments. In the long term, high-quality properties in particular will again be in great demand.

More demanding asset management

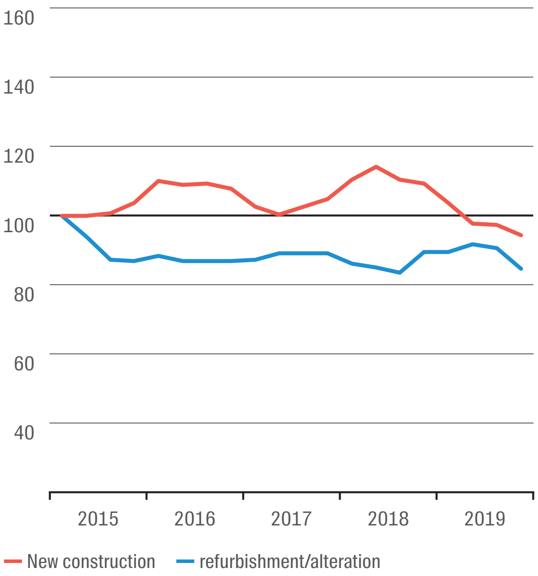
Asset management - especially in the commercial property market - is likely to become much more demanding and also extremely turbulent in the coming weeks and months. New legal issues could arise for which solutions must be found.

Construction industry

New construction activity declines

The Swiss construction industry is likely to experience a temporary slowdown in the current year. Due to the smaller number of planning permissions, it already became apparent last year that there will be less investment in building construction this year. The economic uncertainties are now likely to lead to further delays and suspensions of construction projects by clients. The currently somewhat limited exchange of information between construction market players is also contributing to this. The officially ordered closure of construction sites in various cantons is placing an additional burden on construction companies.

Building construction: planning permissions (index Q1 2015 = 100)



Sources: Baublatt Info-Dienst; Wüest Partner

No slump in construction activity

A slump in construction activity is not expected from the current perspective, but a temporary cooling seems inevitable. After two good weather-related working months in January and February 2020, many of the work already begun should be able to be continued after the coronavirus disruption has subsided. Provided that the pandemic can be contained in the foreseeable future, confidence should return and deferred investments in new construction and conversion work should be continued. Due to the long planning and implementation periods in the construction industry, it has a much more stabilising effect than other sectors.

Energy-efficient refurbishment and the state as support

Declining construction activity is expected primarily in the commercial building sector, but also in the currently particularly exposed alternative sectors such as the hotel industry. In residential construction, an interim cooling is likely. Energy-efficient renovations already planned on a large scale and the state as a developer could become an important pillar for the construction industry in 2020.

Challenging times ahead

Despite the stable situation in recent years, a challenging time is likely to dawn for many construction companies. Measures such as short-time working compensation will at least partially relieve them. For the vast majority of employees in the construction industry, protection through continued wage payments during short-time work and through unemployment insurance will work well.

Rental housing market

Declining number of approvals seen already in 2019

The Swiss rental housing market was in essentially good shape at the beginning of 2020. Although vacancies have recently risen, residential construction activity was already in decline before the coronavirus pandemic broke out. Now there are signs of a further weakening of residential construction activity. This should partly compensate for the declining additional demand for rental housing. Nonetheless, rental prices are expected to continue to fall.

Decline in demand, but housing demand remains unchanged

The development of demand in the current year is likely to be sensitive, but not entirely disrupted. A reduction in employment is likely, which is why population growth could also slow down again. In addition, the formation of small households could decline as a result of budget restrictions. It is precisely the large number of newly formed single households - 52 percent of all new households formed in 2018 were made up of just one person - that has recently led to above-average demand for housing. This development has been made possible primarily by steady economic growth, coupled with low unemployment and slightly rising wages.

Despite the decline in demand, various factors are having a stabilising effect on the rental housing market:

— Housing cannot be substituted, which is why demand cannot collapse.

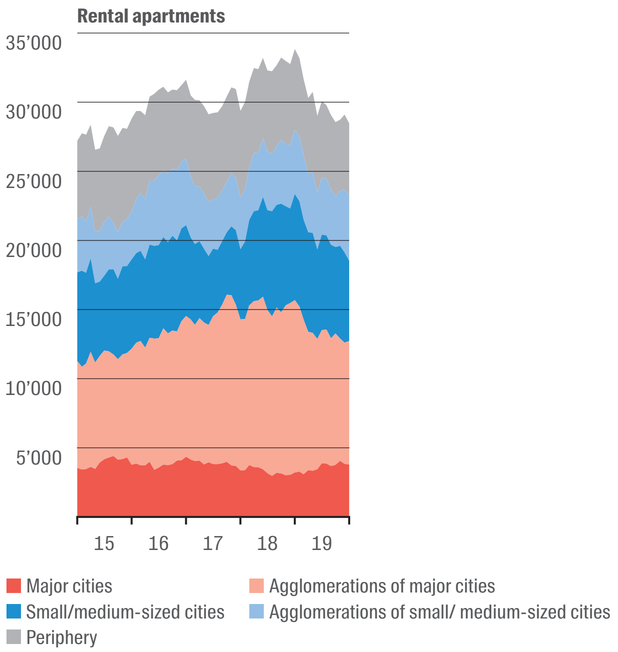
— The expanded social security systems - keywords: short-time work compensation and unemployment insurance - as well as the social security systems in the prospect of immediate federal measures has a supportive effect.

— Rents in existing tenancies are protected and linked to the reference interest rate. It is true that more households than previously could claim rent reductions due to the lower reference rate at the beginning of March. However, tenants are likely to tend to stay in their apartments longer, as rents in new and re-leases are generally higher than the prices in current contracts.

Sub-segments under pressure

Moderate declines in rents and a slight increase in vacancies can be expected for the apartments advertised. Rental apartments in the high-price segment and serviced apartments are likely to come under the most pressure at times.

Number of residential units approved for construction per year and municipality type (moving annual total)



Sources: Baublatt Info-Dienst; Wüest Partner

Soon recovery?

A recovery with compensatory effects is quite possible in the medium to long term, because firstly, the perception of quality living is increasing in the wake of the need to work from home. Second, a reviving economy and the associated rise in demand for housing should one day be accompanied by a reduction in the supply of new construction.

Owner-occupied market

Popular home ownership

Home ownership continues to enjoy unbroken popularity in Switzerland, and the coronavirus crisis will not profoundly change this. On the contrary, the preference for high quality living and owning one's own four walls could even be strengthened during this period.

In the short term, the economic turmoil is likely to restrict the opportunities for acquiring residential property. This is because it is possible that the higher income brackets, which are important for home ownership, will have to cope with declining total wages and losses in value of their own funds in the meantime. This would lead to a dampening of demand for home ownership and thus probably also to temporary pressure on prices for apartments and single-family houses.

Decline in supply - financing environment remains attractive

A declining market supply of new properties is also expected in the residential property sector. The reduced supply has a stabilising effect in the current environment of uncertainty and the short-term decline in demand and willingness to pay. The very attractive financing terms also have a supporting effect. Mortgage interest rates are extremely low and could even fall further. In the absence of lucrative alternatives, pension funds could continue to expand their mortgage business at attractive conditions. If the situation returns to normal relatively quickly, demand for residential property is likely to rise rapidly due to the favourable financing environment.

Prices fluctuate more for owner-occupied apartment than for single-family homes

Experience shows that the prices of owner-occupied apartments fall more sharply than the prices of single-family houses in an economic downturn. This could also be the case in the current situation, although price declines are possible in both sub-sectors. However, according to current information, price slumps are not to be expected.

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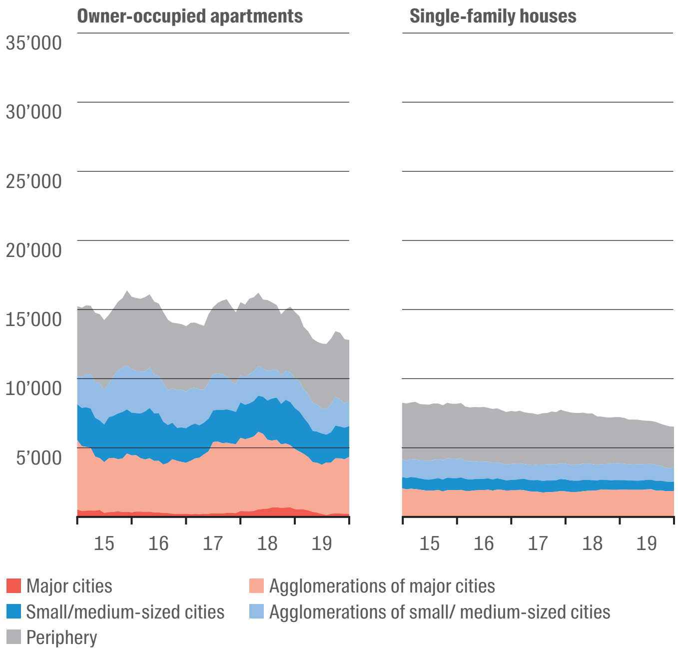

Sources: Baublatt Info-Dienst; Wüest Partner

No credit defaults expected in a brief recession

Even with the current possible decline in market values, the vast majority of residential properties financed are likely to remain above the banks' loan-to-value ratios. Credit defaults and foreclosures would only be expected if the crisis were to last for several years. However, this is not expected at present. There are also strong indications that residential property will lose less value than many other asset classes, such as equities.

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Commercial market

Different starting positions

In the current situation, commercial space must be viewed in a more differentiated manner than ever before: The coronavirus pandemic affects the sub-sectors differently. Individual sectors such as the catering and hotel industry will be hit hard in the short term, while other sectors such as logistics or parts of the pharmaceutical industry will even benefit from the pandemic. Overall, the situation is challenging, and a weakening of the economy with the possible consequence of job cuts will have a negative impact on the commercial space markets in the short term.

Office space market in robust condition

In the largest sub-market in the commercial, office space, vacancies have been reduced in the last two years, and in many places office rents have risen again. In addition, there are signs of declining new construction activity in this sub-market. The markets are therefore facing a new situation in a robust state; in the short and medium term, additional demand for office space can be expected to decline in the wake of the economic downturn. As a result, office rents are likely to fall and vacancies and loss of income are likely to rise. A late-cyclical reaction of the office markets is probable; according to current information, rapid and extensive rent losses are not to be expected.

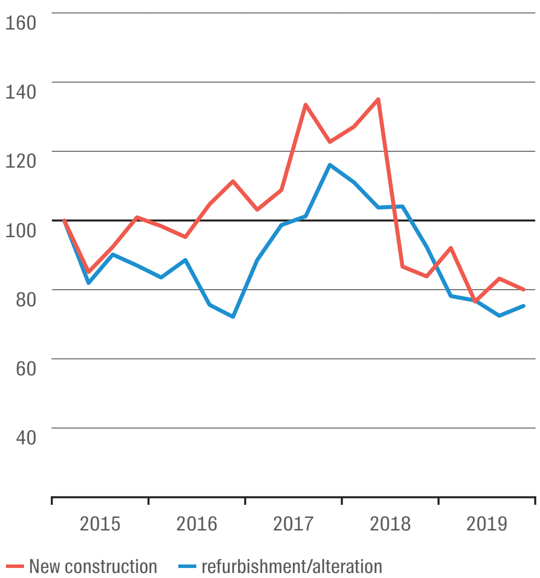
Retail space: accelerated structural change

In the retail sector, the coronavirus pandemic is likely to accelerate the structural change that has been observed for some time. The stationary trade with non-food products will be negatively affected for a short time, while the food sub-sector will remain stable. However, they too could still feel the effects of changed consumer behaviour in the form of increased online purchases. Overall, more favourable market rents are expected. Income from sales-based rental agreements will also fall in the short term. Loss of rent due to bankruptcies is also possible in individual cases.

Some segments will suffer ...

In addition, the following sub-sectors are likely to be confronted with in part significant falls in rents and a variety of challenges: Restaurants, hotels and generally commercial properties with existing vacancies.

Planning permissions: commercial buildings
(office, retail and hospitality industry, index Q1 2015 = 100)



Sources: Baublatt Info-Dienst; Wüest Partner

... but some could also benefit

While the spread of the coronavirus will have a negative impact on the Swiss economy as a whole, some sectors of the economy are likely to benefit from current developments, i.e. demand is currently picking up in some sub-sectors of the real estate market. These include, for example, hospitals and other healthcare properties as well as storage and logistics space or computer centres.

Possible long-term developments

The pandemic will weaken, which will normalise the temporary changes in the real estate market. Nevertheless, the current, profound experiences could change our attitudes and behaviour in some aspects not only in the short term but also in the long term. Sustainable change is conceivable in the following areas:

Increased demand for healthcare properties

Various opportunities will open up for health and hospital properties, as the need for care and security will grow. As a result, a large number of planned hospital closures are likely to be called into question and new investments will be required, which could benefit both public and private clinics.

Storage space gaining in importance

Compared to just-in-time production, stockpiling is gaining in importance, making storage and logistics space more important.

Commuting is out - home office is in

The long-term increase in the number of passengers using public transport during peak hours could level off. Wherever possible, more emphasis will be placed on individual mobility, such as E-bikes. If this model proves its worth now, people will commute less and work more often from home in the future. Consequently, the proximity to the workplace will become less important and the residential attractiveness of commuter communities will increase.

Why roam far away ...

Reflection on the beautiful nearby awakens a preference for holiday and leisure activities close to home. This strengthens domestic consumption and the demand for second homes in Switzerland.

Structural change towards online

The structural change in the retail trade will be accelerated. The E-commerce sector is rapidly gaining further market share at the expense of the stationary retail trade. The additional demand benefits service providers in telecommunications and digitisation.
Service providers are also increasingly turning to digital channels. Specialist events as well as training and further education courses are carried out both classically and digitally. Universities offer their courses digitally throughout the country, which reduces the demand for student accommodation, for example.

Flexibly usable apartments

Privacy and retreat could be given a new boost. A high quality of stay and private retreats are likely to become even more important in residential uses. In apartments, rooms that can be flexibly used and divided up could become more important.

Please do not hesitate to contact us if you have any questions.

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It also draws on the following sources:
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