Real Estate House View
Switzerland

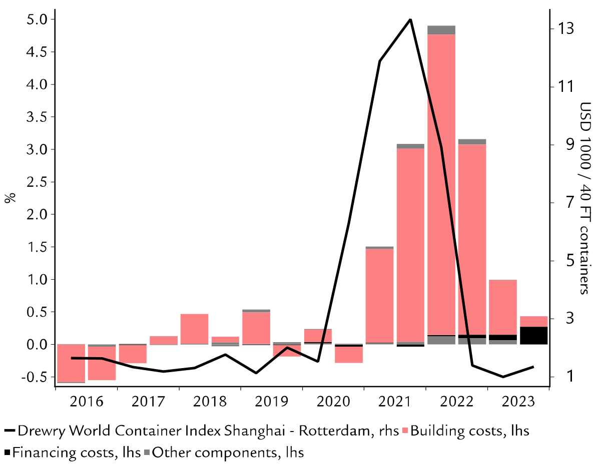
First half-year 2024

Key takeaways

- **Improvement in market security:** It is generally assumed that monetary policy has now peaked, even if inflation is set to rise slightly again in Switzerland mid-2024. As a result, interest rates and interest rate expectations are falling, and investors are re-evaluating real estate investments.
- **Trough near:** As interest rates decline slightly, a new balance in willingness to pay and returns on real estate investments should emerge. Those who act first in this new world can realise greater potential in the long term.
- **Limited access to the right product:** Challenges in the construction sector are limiting the expansion of supply, and as users and investors are focusing on high-quality space, this will be a lifeline for rental growth in the short term despite subdued economic growth.
- **Long-term trends shaping demand:** To ensure the rentability of real estate, investors should pay close attention to long-term trends: strong household growth in Switzerland, the persistently robust labour market and broad-based inward urban development.
- **Value creation through (pro-)active management:** Due to the changed interest rate environment, the daily operational business is increasingly coming into focus. The positive performance of real estate is no longer driven by the monetary policy environment but by income returns and income growth.

Chart in focus

Construction cost components and international freight costs



Sources: Federal Statistical Office, Bloomberg. Last data point: 10.2023

The construction industry will have breathed a sigh of relief. The construction cost index recently rose by just 1.4% year-on-year. The sharp temporary increase thus remains an anomaly triggered by the shortage of supply. Prices for building materials, which are largely imported, were the main driver prior to the rise in interest rates, as the Drewry World Container Index shows. However, no price reductions are expected in 2024. The higher interest on borrowing is set to drive prices until mid-2024 at the latest. On top of this, additional planning requirements could potentially account for up to 2 percentage points of construction inflation.

The underlying macroeconomic and demographic conditions in Switzerland at the beginning of 2024 will bode well for a stabilisation of the real estate market. Long-term mortgage interest rates already fell noticeably in the final quarter of 2023 and, with the prospect of two interest rate cuts by the Swiss National Bank during 2024, financing costs of project developments should also become less expensive again. This prospect of increased planning security and the fact that net immigration to Switzerland over the past 12 months amounted to around 100 000 are supporting domestic demand. The services sector is currently benefiting from this. We also anticipate a recovery in global economic demand so that momentum in industry should pick up in the year. Accordingly, the economic slowdown of recent quarters will only have a minor impact on the Swiss labour market.

Select time and product

General difficulties in the construction industry and the procurement of capital are continuing to hamper the supply of modern properties and make existing high-quality assets a scarce commodity. The moving annual sum of the transaction volumes fell again in the third quarter of 2023 according to RCA and is 65% below the average of the past four years. Construction activity is also continuing its downward trend. In the third quarter of 2023, it reached the seasonally adjusted level of 2006. Muted construction activity is causing investors to take a highly selective investment approach, given the shift towards high-quality, sustainable assets,. Momentum is coming from falling interest rate expectations; both nominal interest on government bonds (see Chart 1) and mortgage interest rates have fallen significantly since their 2022 peaks. This raises the question: when is the right time for a return to or start of a construction project. The premium between nominal interest and prime real estate yields is currently increasing and should already be around one percentage point for a large share of investment opportunities. With mortgage interest rates slightly above 2% and more stable construction costs, many projects are also becoming profitable again. The prerequisite is, of course, long-term demand for space by tenants. This still seems to exist in many places. From a sectoral perspective, the trends observed in 2023 continued: net immigration is expected to remain above previous years, supporting consumption, and generating employment growth. Market rents for residential property are thus expected to rise by 1% to 5% year-on-year, and even more in the cities.

Low vacancies in the CBDs

The latest data confirm that commercial space in prime locations is the most sought-after even though office space in general is under pressure due to the continued reduction of space. According to CBRE, the availability rate increased to 9.8% in the suburbs in the fourth quarter of 2023, while in central business districts (CBDs) it only slightly above pre-pandemic levels at 3.8% (see Chart 2). Asking rents have responded accordingly: recent Wüest Partner figures show a decline in asking rents for office space in Switzerland. At the same time, they are rising in the top markets of Zurich and Geneva and remain slightly above pre-pandemic levels in the other larger cities.

Applied research eagerly addressing construction issues

Anyone studying the latest research contributions or those submitted to the CUREM programme will notice that topics related to construction are becoming more and more prominent. This is not surprising in view of the growing complexity of the construction industry. If you look closely, however, you will also notice that the focus is not just on construction per se, but increasingly on the groundwork, or ‘pre-construction’ phase. Evaluating this phase is becoming more challenging, given growing complexities related to technical, economic, environmental, social, and therefore architectural issues. This is having a knock-on effect to project development risks, which have increased as a result. That said, benefits are also emerging, as these issues are forcing agents to work in a more solution-oriented manner. One can expected that well-thought-out projects will command a greater majority of support and thus offer less scope for appeal. Ultimately, taking a rigorous approach to the pre-construction development phase will serve as a critical step to mitigate against the ever-increasing “brown discount”, which would otherwise be inevitable for energy inefficient assets.

Chart 1: lower interest rates in the medium term slowing down the rise in real estate yields

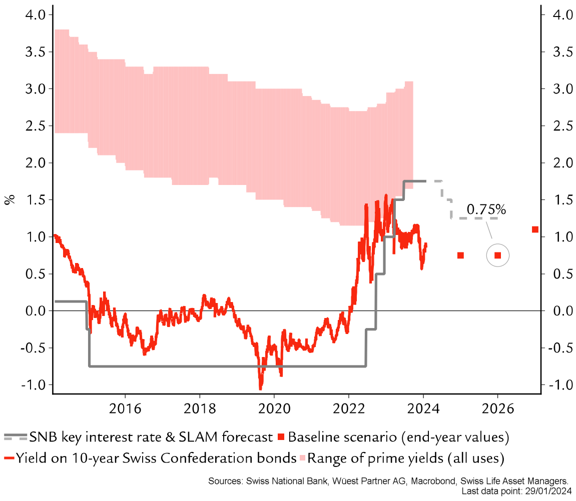
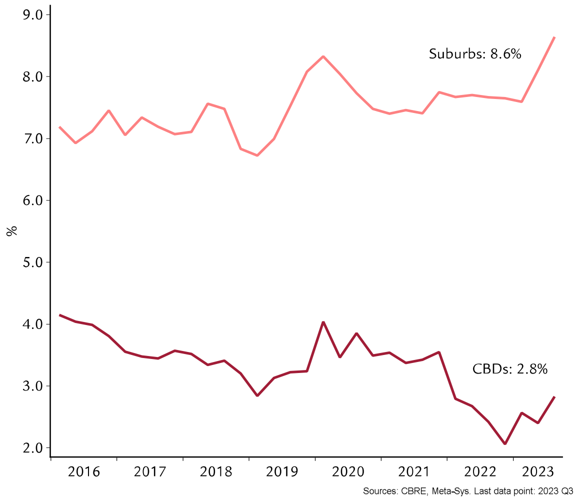


Chart 2: CBDs most in demand amongst office users: office availability by submarket



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