macro
REAL ESTATE
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Real Estate White Paper:

Reassessing the perspectives of Swiss commercial real estate for international investors

Executive Summary:

- Switzerland is an attractive and stable economy supported by strong population growth and benefits from international immigration of highly skilled labor. The Swiss economy has demonstrated its resiliency vs. shocks during multiple crises, as seen recently during the global inflation shock.
- Switzerland's "safe haven" benefit has led to an appreciation of its currency over the long term and the advantage of one of the lowest interest rates internationally. This still leads to quite attractive levels of mortgage rates despite the global increase in interest rates
- Swiss commercial real estate can be a good diversifier in pan-European or global real estate investment portfolios due to the low or even negative correlation of its returns with international indices
- Real estate yield levels are typically lower in Switzerland compared to other European countries. Still, the current situation leads to some adjustments of yields to somewhat higher levels in Switzerland
- Due to healthy rental market fundamentals, we see the current market situation as an exciting entry point for international buyers to build up exposure in Switzerland

Introduction

In the past, international investors have overlooked Swiss commercial real estate despite its robust risk-adjusted performance characteristics. On the one hand, Swiss real estate investment managers and intermediaries have concentrated on soliciting and allocating domestic capital due to domestic solid interest and the abundance of Swiss institutional capital.

On the other hand, Switzerland's stringent data protection and confidentiality standards have served to deter foreign entrants. To a large extent, dealmaking in Switzerland's real estate investment market relies heavily on personal relationships.

Looking at the stable historical numbers and substantial diversification benefits of Swiss commercial real estate in pan-European portfolios, this was – in hindsight- a missed opportunity.

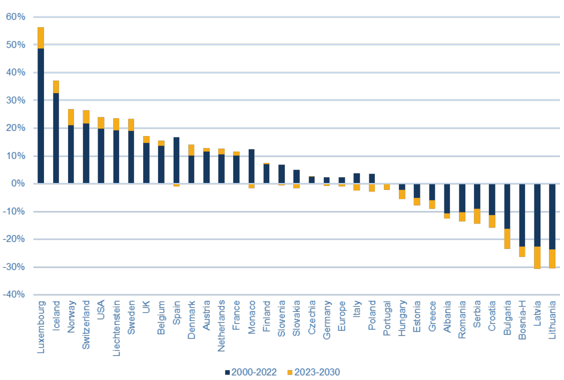
The merits of Swiss commercial real estate will likely gain more importance as the world is sailing economically and geopolitically into choppy waters. This white paper sets the case for Swiss commercial real estate from an international investor's perspective.

"Safe haven" benefits of the Swiss economy

Commercial real estate investments involve investing in tangible assets that are predominantly influenced by the medium to long-term performance of the real economy. So, the mid to long-term perspective of the economy matters.

Switzerland remains one of Europe's leading economic centers due to its high quality of life, pro-business policies (low taxes), and sound fiscal policies. This has resulted in high net immigration numbers.

Figure 1: Population growth by country in %



Source: UN Population Database, Stone Estate Swiss

As Figure 1 highlights, the population increased in Switzerland, according to the data from the UN by nearly 22% since the turn of the millennium. This increase was already larger than in the United States, ranking Switzerland as one of the strongest European countries. The UN population experts project a further 5% growth until the end of this decade.

Further vital institutional factors are Switzerland's comparatively low levels of government debts (<50% of GDP) that allow the citizens to benefit from relatively low tax rates for companies and individuals.

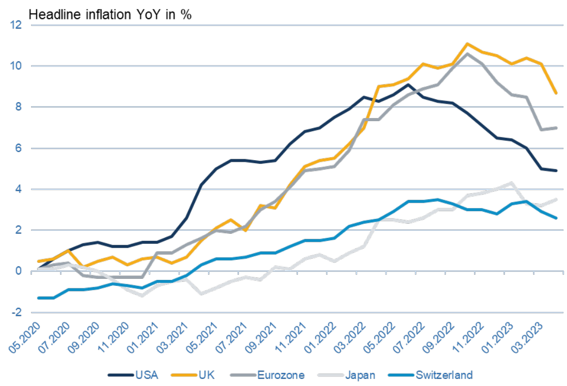
Outperformance at times of economic shocks

These robust features become more important in times of global economic or financial market turmoil. The famous Lebanese American essayist and trader Nassim Nicolas Taleb even named Switzerland in his book as one of the examples of "anti-fragile."

During periods of global economic recession, weaker countries with fragile economies often experience a crisis. However, Switzerland has shown in different such episodes that it tends to emerge as a beneficiary. This trend was also observed during the Global Financial Crisis (GFC). Switzerland has benefited from a surge of migration from Southern Europe, as unemployment surged in Spain, Italy, and Portugal.

Notably, while real estate valuations sharply corrected in other regions during that time, Switzerland maintained a more stable market.

Figure 2: Inflation in %



Source: Bloomberg, Stone Estate Swiss

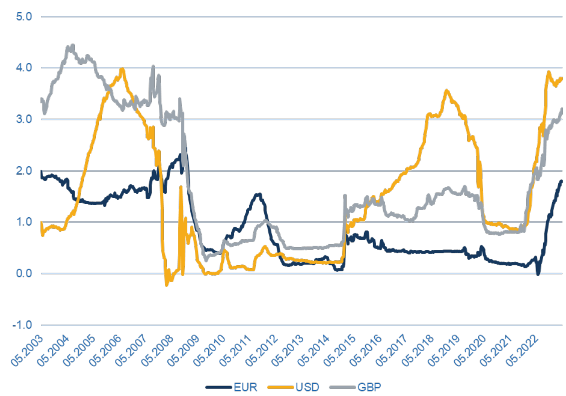
The resilient Swiss characteristics could also be observed in the recent global inflationary shock. While inflation has surged into double digits even in neighboring countries such as Germany, Swiss real estate inflation peaked at 3.6% and is already approaching the 2% target of the Swiss central bank.

This is not a random outcome. We have analyzed the episode of the 1970 inflation, and the same happened then. Moreover, it brought along in the 70ies a strong outperformance of Swiss real estate vs. UK and Europe.

Benefits of relatively lower Swiss interest rate levels

A main macroeconomic outcome of its safe haven characteristics is a favorable interest advantage for Switzerland. Figure 3 illustrates that major currencies tend to exhibit significantly higher interest rates levels compared to Switzerland.

Figure 3: Relative 3M interest rate levels vs CHF



Source: Bloomberg, Stone Estate Swiss

As a result of the recent global inflation shock, the interest rate differential vs. CHF is now excessively high. It is 3.8% for the USD, over 3.2% for GBP, and 1.8% in the EUR. But looking at the averages, over the last twenty years CHF 3M rates were 0.86%, 1.49%, and 1.78% lower vs. EUR, USD, and GBP.

This has two significant implications for investors in Swiss real estate markets. On the one hand, Swiss real estate investors benefit from lower mortgage rates than in other currencies. While current mortgage rates are around 4.5%-5.0% in EUR and over 6% in GBP and USD, Swiss investors can obtain funding at mortgage interest rates sub 3%.

On the other hand, the positive interest rate differential has the additional benefit that hedging the Swiss franc exposure yields an additional return for foreign investors. As mentioned above, this interest rate differential can enhance yields of Swiss investments by almost 3.8% p.a. for USD based investors.

The Swiss franc continued to strengthen

The alternative to hedging the FX exposure is to add Swiss commercial real estate to their Swiss franc currency portfolios.

Figure 4: Outperformance of CHF vs major currencies

Source: Bloomberg, Stone Estate Swiss

Figure 4 shows the relative performance of investing 100 CHF from the currency perspective over the last twenty years. The CHF appreciated more than 80% vs. GBP and 50%-60% vs. EUR and USD. While there is no guarantee for these to be replicated in the future, the institutional factors supporting the CHF are in the current environment more valid than ever. The CHF appreciation trend is not a short-term but a long-term phenomenon.

So, the investor has the choice of whether to hedge and earn additional yield or benefit from the safe-haven characteristics of the Swiss franc over the long term.

Swiss CRE has the critical scale

We are now turning from the major macro factors to the specifics of the Swiss real estate market. Due to regulation that only allows domestic investors to invest in residential properties (Lex Koller) we have not included the residential multi-family sector in our analysis.

However, this is the biggest sector with an estimated market value of 1.2trn CHF.

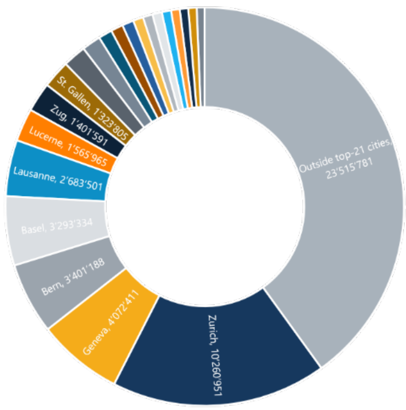
Based on data from Wuest Partner, a leading appraiser in Switzerland, we estimate the value of the investable commercial real estate market at around 650bn CHF. The office is the biggest and most liquid sector, estimated at 350 bn CHF, followed by retail at 180bn CHF.

Office market: Zurich is by far the biggest market

The Swiss office market amounts to 58mn sqm. Zurich is with a population of 440k the biggest Swiss city. It is by far the most prominent office market with 10.2 mn sqm of office space and a share of roughly 20% of the total office space in Switzerland. It is twice the size of Geneva (stock 4mn sqm), Switzerland's second-largest office market.

As commercial property values are the highest here, Zurich's market value is much more dominant. So, Zurich might be a good starting point for building a Swiss commercial real estate portfolio.

Figure 5: Distribution of Swiss office stock by sqm



Source: Wuest Partner, Credit Suisse

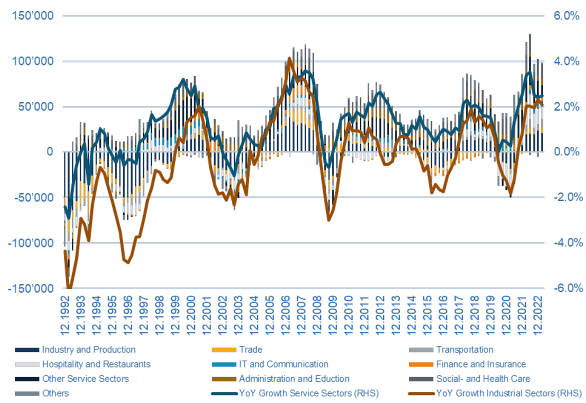
Healthy office market fundamentals

In contrast to the situation in the US or some other large cities globally, office markets in Switzerland structurally benefit from the very short commuting time and integrated office space into residential or mixed commercial neighborhoods. This might also be a key driver of why structurally office fundamentals have even strengthened since the outbreak of the pandemic. The amount of vacant space 2022 was reduced by 10% in Switzerland on an aggregate basis.

Some larger companies in Switzerland have also endorsed the trend toward more flexible work models, but central space is still in high regard. This might be in addition to the short commuting time due to workers' preference for the high amenities and more modern building quality.

Some of the negative effects of "home offices" are found in less central office space locations, such as near the two major airports of the countries. These are on the one hand "Zurich Nord" and on the other less central space in Geneva.

Figure 6: Employment growth in Switzerland



Source: Wuest Partner, Credit Suisse

An important demand driver is the strong employment growth in Switzerland. Figure 6 shows the net change of full-time equivalent employees by the sectors in Switzerland.

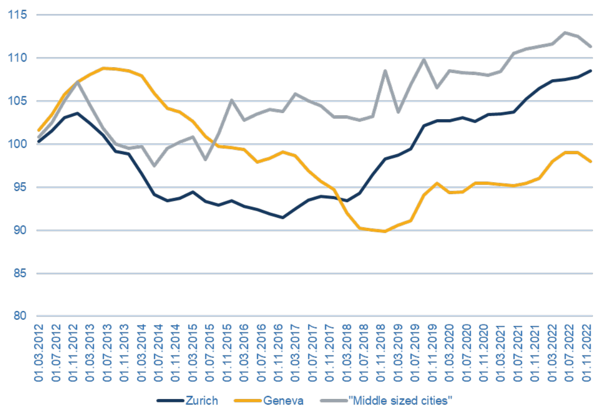
In Q1 2023 we have seen in both the service as well as the industrial sector a solid increase in employment of more than 2% YoY or in absolute terms over 100'000 employees YoY. Meanwhile, the Swiss unemployment rate was very low with 2% in May 2023.

Office as best use at higher floors at central prime locations

As a result of this solid demand, office vacancy rates in inner city locations are at quite low levels. They are at 1.5% in Zurich, 2.5%-3% in Lausanne, Bern, and Basel, and around 4% in Geneva. Due to the high levels of prime office rents in both cities (900-950 CHF), the office remains the best use for prime space at central locations for prime buildings.

Ample anecdotal evidence supports these considerations. In Zurich, Bahnhofstrasse, the top high street in Switzerland, two historical buildings that used to house department stores for more than a century have been taken offline and are now in redevelopment. The highest floors are converted in both buildings (different owners and investment managers) into prime ESG-compliant offices, as this use yields the highest expected revenue.

Figure 7: Office rents from contracts concluded



Source: Wuest Partner, Stone Swiss Estate

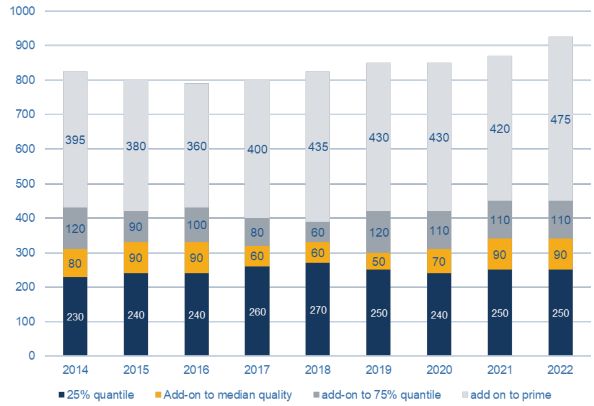
So, it's unsurprising that office rents continue to increase. In 2022 we observed an increase in office rents by 2.2% on a country level (based on a hedonic index of actual concluded rental contracts, that accounts for quality adjustments).

Quality spreads support value-added strategies

In Figure 8, we look at Zurich's central locations at the evolution of asking rents. The chart highlights the rental evolution from 25% quantile to prime quality. To illustrate the widening spreads, we show the rents as an add-on to the respective lower quality. The rent for the lowest quartile has remained at 250 CHF psm, while the prime rent has increased in recent years and has reached 925mn CHF psm by the end of 2022.

The chart illustrates the growing demand for modern refurbished prime-quality office space as the spreads between prime to lower-quality rents have increased in recent years.

Figure 8: Zurich city office rents by category



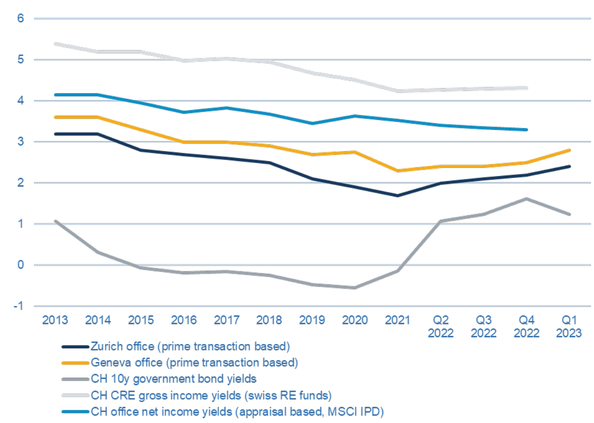
Source: JLL, Stone Swiss Estate

Limited increases in property yields

The levels of real estate yields are typically lower in Switzerland than in other European countries due to the interest rate advantage of Switzerland.

Figure 9 shows the evolution of different CRE real estate yield measures. Due to the long-lasting negative interest rate period in Switzerland, property yields were under downward pressure, as investors allocated more and more capital to real estate. Net prime office yields in Zurich (transaction based) even dipped in the course of the pandemic to below 2%.

Figure 9: Evolution of office yields



Source: Wuest Partner, JLL, Stone Swiss Estate

Over 2023, property yields nudged upwards, as interest rates rose. JLL indicates the current prime net office yield for Zurich at 2.4% and 2.8% for Geneva.

According to the fund valuations and the MSCI IPD database, which utilize appraisal-based methods, the average gross income yields for commercial real estate (CRE) in Switzerland stand at 4.5%. The country's net cash flow returns for CRE are estimated at 3.5%.

Switzerland has experienced a modest rise in bond yields and interest rates compared to other European countries. This can be attributed to the fact that inflation in Switzerland is among the lowest in Europe. Consequently, the Swiss market's need to adjust real estate capitalization rates upwards is less pronounced.

Current market situation a chance for international capital

Liquidity has also been impacted somewhat, and the bid-ask spread in property transactions has widened, mainly due to the denominator effect. This implies that domestic institutional investors have less capital available for new investments.

As Swiss property transactions were subject to competitive bidding processes in the past years, the current situation can be seen as a better entry point for international investors than some years ago.

The current market conditions present a unique opportunity to acquire high-quality properties in desirable locations that would typically be unavailable. Simultaneously, it allows for favorable pricing, resulting in improved yield prospects.

The rental market analysis demonstrates that core+ and value-added strategies are attractive due to high rental spreads between low and higher-quality buildings.

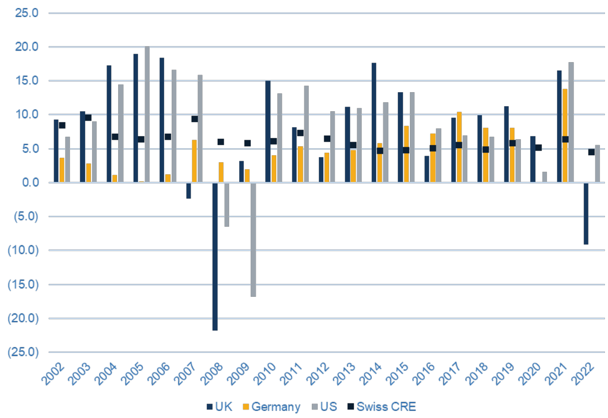
Yields are still somewhat lower in Switzerland and won't reprice as much as elsewhere in Europe. But as demonstrated above international investors are compensated either by earning an additional interest via hedging the CHF exposure or going long a safe haven currency that tends to appreciate over time.

Good diversifier in multi-country real estate portfolios

A final consideration to be made is how Swiss commercial real estate fits into international real estate portfolios.

Figure 9 shows the evolution of Swiss commercial real estate (a blend of the office, retail, and logistics sectors) compared with multi-sector indices in the UK, German, and US property over the last twenty years.

Figure 9: Comparison of total returns of core unlevered real estate investments (in LC)



Source: MSCI, INREV, Wuest Partner, Stone Swiss Estate

Figure 9 illustrates the stability of Swiss real estate returns. It also shows the relatively lower volatility of Swiss real estate compared to other country levels. It's visible that during the GFC and the pandemic, Swiss real estate returns only slowed down, while they fell elsewhere.

To some part, the higher volatility of returns in the US and UK is due to the mark-to-market features of Anglo-Saxon valuations. But also vs. the German market, which follows a similar valuation philosophy, Swiss real estate tends to outperform during downturns.

The relatively stable return features usually come at the expense of a more limited upside during booms. In 2021, when property values strongly appreciated outside of Switzerland, Swiss commercial total returns only were slightly higher than in 2020.

But in a portfolio context, this stability is a precious feature.

Table 1: Correlation coefficient of Swiss real estate with international property indices

	UK	Germany	US
Swiss office	-0.07	-0.10	0.23
Swiss retail	-0.13	-0.18	0.15
Swiss logistics	0.04	-0.46	0.18

Source: MSCI, INREV, Wuest Partner, Stone Swiss Estate. The correlation coefficients were computed based on annual total returns 2002-2022

Table 1 illustrates the correlation coefficient between the three Swiss CRE sectors with the diversified property level indices in the UK, Germany, and the US. The low positive and even negative correlation coefficients show that the addition of Swiss real estate into international property portfolios can substantially improve the risk-return characteristics of investment portfolios.

Conclusion:

Switzerland's inherent "anti-fragility" contributes to the safe-haven advantages offered by the Swiss economy and currency, which serve as significant drivers for the risk-return characteristics of Swiss commercial real estate.

As the Swiss economy is more resilient in times of shocks, the real estate cycle tends to be characterized by more limited volatility than in other countries.

For international investors, this also has the benefit that Swiss real estate can be a good diversifier in pan-European or global portfolios due to the low or even negative correlation of its property returns with international indices.

The consequence is that a portfolio that also includes to some degree Swiss real estate has a better risk-return characteristic than a portfolio without Swiss exposure. To put it differently: An international portfolio that includes Swiss real estate can achieve a higher return with similar risks.

Still, the current situation leads to some adjustments of yields to somewhat higher levels in Switzerland. Due to the balanced rental market fundamentals, we see this, as an interesting entry point for international buyers to build up exposure in Switzerland.

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