RESIDENTIAL PROPERTY OUTLOOK 2024

Market trends and investment opportunities

In this analysis, we highlight the key developments in the residential yield property market over the past two years and formulate well-founded expectations for the coming year 2024. We comment on important developments and analyse the dynamics that are shaping this asset class. This analysis serves as a guide that looks at recent changes in the context of inflation and interest rate rises and draws conclusions for future market opportunities. It is aimed at all investors who want to delve deeper into understanding current market conditions and gain a clear perspective for their investment strategies.

Key developments and future prospects

Challenges in the property sector: 2022 and 2023 were characterised by challenges in the property market, influenced by high inflation and interest rate hikes, which led to value corrections and market changes.

Return to lower interest rates: Due to the decline in inflation, interest rates are expected to fall, which should lead to a harmonisation of yield expectations and an improvement in market liquidity.

Stable income from residential investment properties: Residential investment properties are characterised by their crisis resilience and adaptability of income, which makes them an attractive asset class, particularly in the current macroeconomic environment.

Excess demand in the rental flat market: The rental flat market is characterised by high demand and a shortage of supply, which leads to higher letting rates and better income prospects.

Property in the asset allocation: In an uncertain investment environment, property offers a more stable option and protection against inflation, recession and geopolitical risks compared to other asset classes.

Focus on sustainability: Institutional investors are increasingly demanding higher standards by firmly integrating sustainability criteria into their investment strategies. Although this increases complexity, sustainability and profitability can certainly be achieved together.

Positive outlook for residential investment property in 2024: A positive trend in the residential investment property sector is forecast for 2024, based on robust fundamentals and macroeconomic changes, which will lead to increased market liquidity and new investment options.

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2022 and 2023: Difficult years for property investments

The last two years have been characterised by a period of upheaval in the property sector, which has been challenging for investors. This period, characterised by high inflation and the resulting interest rate hikes, signalled the end of a long period in which real estate was seen as an investment that would steadily increase in value. For institutional investors in particular, who had focused on property investments for years due to a lack of alternatives, the abrupt rise in interest rates brought with it a new reality: their property portfolios were suddenly faced with the possibility of significant value corrections.

The effects of the new interest rate environment were felt on the markets in different ways. Listed property assets, such as property funds, reacted quickly to the changes due to their higher liquidity and tradability, resulting in a significant fall in prices and thus a reduction in premiums (Figure 1).

On the direct transaction market, however, there was a noticeable discrepancy between the price expectations of buyers and sellers. While the buyer side endeavoured to use the changed interest rate conditions to their advantage and calculate with higher discount rates, many property owners insisted on long-term, historical discount rates and largely ignored the latest interest rate increases. This gap led to a stagnant market and a decline in liquidity, which made pricing even more difficult (Figure 2).

However, a positive change in the property market is expected in 2024. The combination of strong fundamentals and the anticipated realignment of monetary policy points to favourable prospects for property investors, signalling a welcome departure from the current market turbulence.

The way back to low interest rates

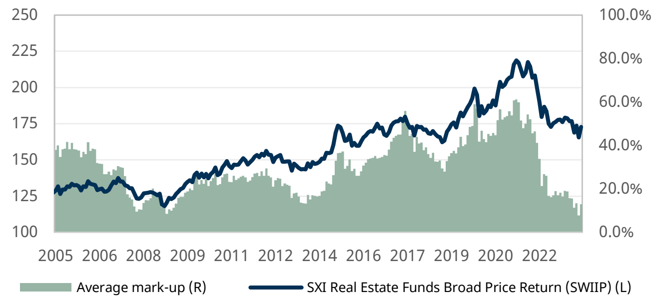
The peak in interest rates resulted directly from persistent inflationary pressure, driven by exogenous factors such as supply bottlenecks and rising commodity prices due to global logistics disruptions. The SNB has so far successfully contained these price increases through a targeted appreciation of the Swiss franc and an increase in the key interest rate.

With the incipient decline in inflation, a weakening of market interest rates is also becoming apparent, which are already signalling interest rate cuts of at least half a per cent for the coming six months. This indicates that no permanent increase in structural inflation and therefore interest rates is expected. Accordingly, market interest rates should return to a lower level as soon as inflation loses further significance, which is only a matter of time (Figure 3).

Regardless of the duration and extent of this development, the overall picture shows that the rapid rise in long-term interest rates can be regarded as a temporary event. This development suggests that the recent rise in purchase yields is unlikely to continue (Figure 4). As a result, a harmonisation of yield expectations between buyers and sellers can be expected, which should not only improve pricing but also noticeably increase liquidity on the transaction market.

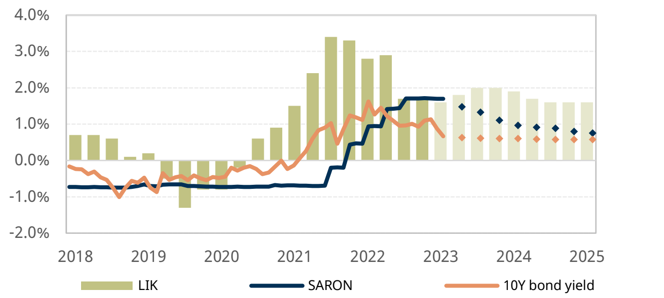
In addition, lower interest costs combined with a less restrictive monetary policy will lead to more accommodating lending conditions, which should further stimulate demand. Monetary policy in 2024 will therefore help to clarify valuation differences with regard to discount rates and reduce interest rate uncertainty, which will provide significant impetus for yield-producing properties.

Figure 1: Sharp fall in prices for listed property funds and reduction in premiums



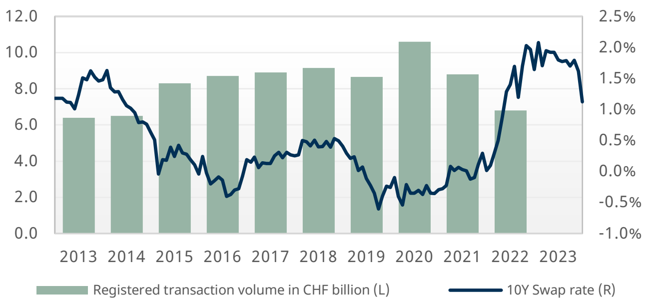
Note: The chart shows the price development of the SXI Real Estate Funds Broad Index (SWIIP) (right axis) and the development of the average premium of all listed property funds that are invested exclusively in Swiss real estate (left axis).
Source: Data from Bloomberg, SIX Group AG, as at 22.12.2023

Figure 3: Expected trend towards lower inflation and lower interest rates



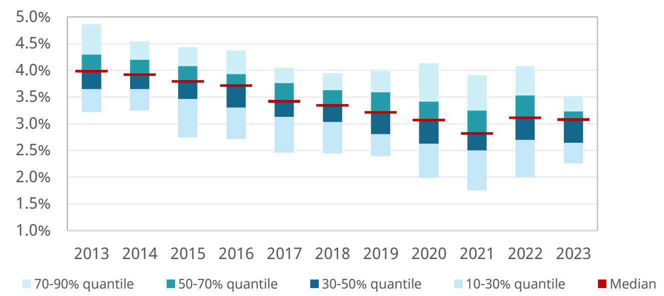
Note: The chart shows inflation (CPI), SARON and yields on 10-year government bonds. The underlying inflation expectations are based on SNB forecasts. The forecast values for SARON and bond yields are derived from market values and our own analyses.
Source: Data from Refinitiv Eikon, SNB, Avobis, as at 22 December 2023

Figure 2: Higher interest rate environment accompanied by decline in transaction volume



Note: The chart shows the registered transaction volume of residential and commercial property investments recorded by CBRE in CHF billion (left axis) and the historical development of the 10-year swap rate (right axis).
Source: Figure based on CBRE, as at 22/12/2023

Figure 4: Slight increase in purchase yields



Note: The chart shows the net initial yield (before CAPEX), defined as the ratio of the net rental income to the gross purchase price. It visualises how the net rental income relates to the purchase price and thus provides an overview of the profitability of property investments.
Source: Figure based on Wüest Partner, as at 22.12.2023

Improved risk/return profile thanks to earnings potential

Thanks to their crisis resilience and the generation of constant income, residential investment properties are proving to be an attractive asset class. In the current economic situation, they are characterised by the adaptability of their income, which offers effective protection against a real loss of income (Figure 5). A key element here is the inflation-linked rent structure, which allows for an increase of up to 40% of the inflation rate in addition to a general increase in costs.

The rent is also determined by the mortgage reference interest rate, which is based on the average interest rate of all existing mortgages. A prolonged rise in interest rates, which is reflected in higher mortgage interest rates for a large proportion of outstanding loans, results in an adjustment of the reference interest rate. For every increase of a quarter of a percentage point, a rent increase of up to 3.0% is possible. The reference interest rate has already been adjusted twice, which has a positive impact on earnings. Due to the calculation method, a short-term reduction in the reference interest rate is unlikely in an environment of falling interest rates, which means that the earnings situation should remain higher in the medium term.

Falling interest costs and easing inflationary pressures, such as maintenance costs, are helping to reduce costs and thus improve profit margins. In addition, the existing surplus demand and the limited supply of rental flats increase income security, which minimises the vacancy risk and enables more effective use of the potential for rent increases (Figure 6).

Overall, we are forecasting a significantly improved risk/return profile for residential investment property in the medium term.

Growing demand meets supply shortage

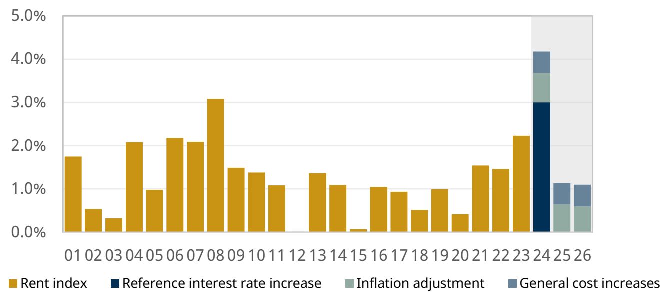
The current situation on the rental housing market is characterised by high demand and limited supply. This dynamic demand is primarily driven by an increase in the number of households, a stable employment situation and, in particular, the increasing immigration of high-income workers (Figure 7). The positive development of the labour market and Switzerland's continued attractiveness as a location are ensuring that demand for housing remains high.

On the supply side, however, the market is showing a hesitant response. Even before the pandemic, a construction boom ended in an increase in vacancy rates, which reduced the attractiveness of new construction projects and ultimately led to a decline in construction activity. This development has not yet been able to recover and has been further restricted by higher and volatile construction prices and interest rates and, not least, regulatory obstacles. As a result, the supply of housing has not increased significantly in recent years, although there is strong demand that could easily absorb additional supply.

Falling interest rates and declining inflation are expected next year, which will reduce planning uncertainty with regard to construction and financing costs and improve the prospects for returns. Despite this outlook, order volumes have so far remained limited (Figure 8), which indicates that construction investment will remain subdued.

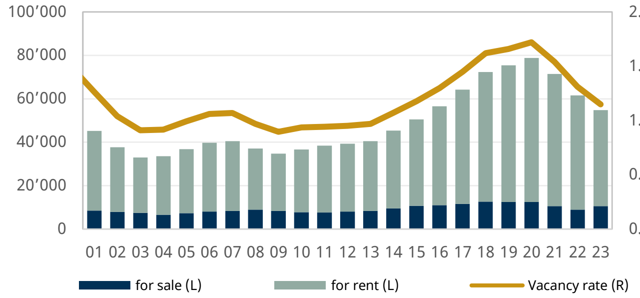
In the short to medium term, supply is unlikely to meet rising demand, which will require the market to adjust over a period of years. For landlords, this offers the opportunity for higher letting rates and better earnings prospects. Construction projects are also likely to become more attractive and profitable next year thanks to improved financial conditions and planning certainty.

Figure 5: Potential for rent increases supports the income side



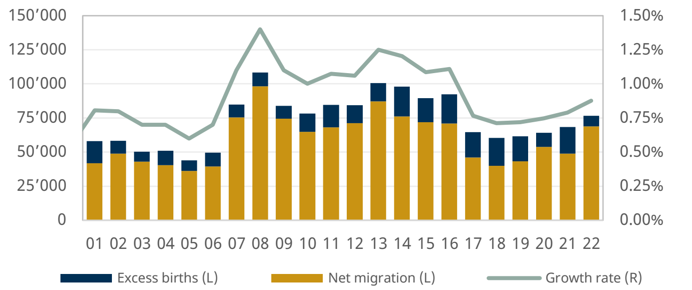
Note: The values shown represent the annual growth rates of the rental price index. No change in the mortgage reference interest rate and an inflation adjustment in line with the SNB inflation forecast is expected for the forecast period. An annual general cost increase of 0.50% is also taken into account. Rent increases due to investments were not taken into account.
Source: Data from BfS, SNB, Refinitiv Eikon, as at 22.12.2023

Figure 6: Supply shortage is noticeable in the decreasing vacancy rate



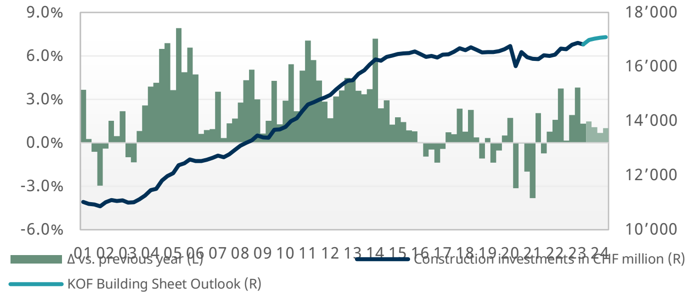
Note: The vacancy rate is calculated as at 1 June.
Source: Data from BfS, as at 22.12.2023

Figure 7: Population growth mainly driven by immigration



Note: The figure shows the development of the permanent resident population in Switzerland. The birth surplus also includes changes due to population adjustments.
Source: Data from BfS, as at 22.12.2023

Figure 8: KOF Construction Outlook points to moderate construction investment



Note: Based on building permits, the KOF has developed an outlook that allows a forecast of the nominal construction investment to be expected over the next four quarters. The KOF Construction Outlook is published four times a year. It shows the expected investment expenditure in CHF million (right axis) and the previous year's rates of change (left axis).
Source: Data from KOF, as at 22.12.2023

Assessment from an asset allocation perspective

The current investment environment remains challenging for investors. They are faced with the task of identifying investments that perform robustly in an environment characterised by inflation, geopolitical tensions and recessionary tendencies and have as little correlation as possible to these risk factors. Property as an asset class can outperform other assets such as equities and bonds in such times. It should therefore be included in every portfolio for asset allocation reasons.

Due to the current high level of interest rates, fixed-interest bonds are becoming more attractive again compared to property investments, especially after a longer period of negative interest rates (Figure 9). If interest rates fall as forecast, this asset class could realise significant capital gains. However, investors in bonds are exposed to risks such as unexpected inflation and refinancing risks. This relates to the risk of not being able to refinance the capital at the same or even higher interest rates. Property prices, on the other hand, show a similar sensitivity to interest rates, albeit perhaps not in the short term, and do not harbour any significant refinancing risk. In addition, as explained, they offer protection against inflation and thus counteract a real loss of income.

The current economic outlook is positive, but below the long-term average (Figure 10). A recession is unlikely, but subdued growth could dampen stock market performance. Global interdependencies between companies could limit domestic markets in view of geopolitical and global economic uncertainties. However, residential property is less affected by these risks and therefore offers a more stable investment option.

Sustainability in the focus of many pension funds

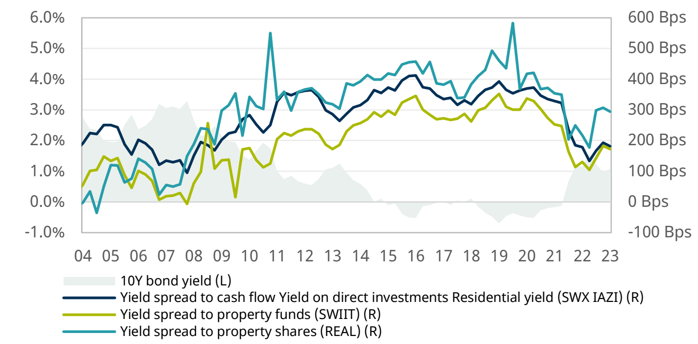
The Swiss building stock is crucial for achieving climate targets. The need to reduce CO^2 emissions requires players such as pension funds to deeply integrate sustainability criteria into their decision-making (Figure 11). These new requirements are leading to an adjustment of investment strategies, which not only have to pursue a green vision but also remain profitable.

A key challenge here is to translate sustainability into a measurable parameter. The current data situation and the variety of certificates and standards make this task challenging. The industry is currently focussing on the reduction of CO^2 emissions as the common denominator for sustainability efforts. However, the need for meaningful data and analyses remains.

With this new focus, portfolio composition is becoming increasingly complex, as financial considerations have to be complemented by environmental objectives. Properties that are difficult to renovate are becoming less attractive, while sustainable properties are being favoured. This leads to a growing interest in sustainability-compliant investment properties and products or investment vehicles that are both profitable and in line with environmental investment objectives.

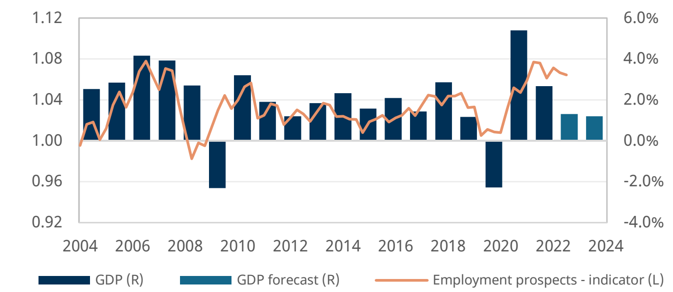
Although the increased complexity and higher costs pose challenges, studies show that these can lead to increased returns (Figure 12). Sustainable properties are characterised by higher rental income and lower ancillary costs, which contributes to higher net income. In addition, a higher occupancy rate, lower regulatory risks and more efficient wear and tear in sustainable properties lead to a reduced capitalisation rate, which further increases the overall value of the property.

Figure 9: Yield spreads on residential property investments are likely to increase again



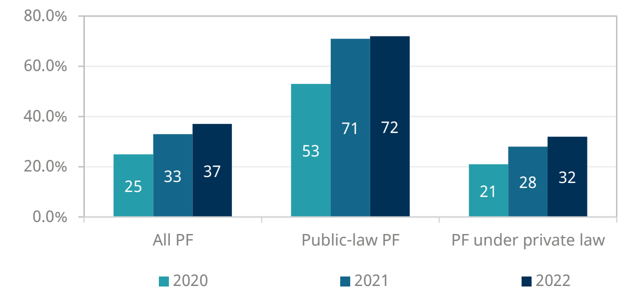
Note: The left axis shows the bond yield of 10-year federal bonds. The right-hand axis shows the yield premiums of various property investments over the bond yield in basis points (bps).
Source: Data from SIX Group AG, IAZI, Refinitiv Eikon, as at 22 December 2023

Figure 10: Challenging investment landscape with a moderate economic outlook



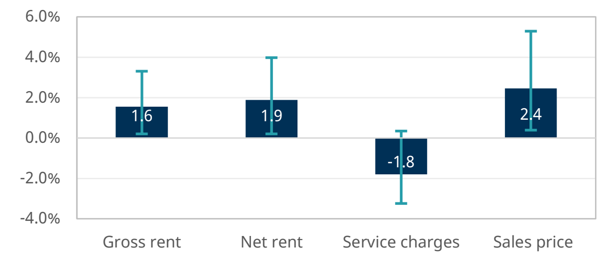
Note: The chart shows the development of GDP and the employment outlook. A value of 1.00 means that total employment is expected to stagnate in the next quarter. For values above 1.00, an increase in the total number of employees can be expected. The forecasts for GDP growth are based on the SECO economic forecasts of 20 September 2023.
Source: Data from BfS, SECO, as at 22.12.2023

Figure 11: Proportion of pension funds that integrate ESG criteria into the investment process



Note: The chart shows the percentage of pension funds (PFs) for which ESG criteria are anchored in the investment regulations. The results are based on the surveys conducted as part of Swisscanto's Pension Fund Study 2023. However, it should be noted that only a third of the pension funds surveyed responded to this specific question.
Source: Figure based on Swisscanto, as at 22.12.2023

Figure 12: "Green Premium" in rental and sales prices - An analysis illustration from the Canton of Zurich



Note: The chart illustrates the analysis of "green premiums" for sustainable residential properties in the canton of Zurich, based on a hedonic price model and data from homegate.ch from 2010 to 2017. It shows the average premiums and their fluctuation ranges for gross rents, net rents and ancillary costs as well as sales prices for certified properties.
Source: Study results by Constantin Kempf & Juerg Syz, 2022 "Why pay for sustainable housing? Decomposing the green premium of the residential property market in the Canton of Zurich, Switzerland".

Outlook 2024: encouraging prospects for residential property

Our forecast for the residential investment property market in 2024 is consistently positive due to solid fundamental data and a predicted macroeconomic change. This analysis allows us to outline the following prospects:

Revival of market liquidity: In anticipation of lower interest rates and due to positive fundamental factors, the attractiveness of residential investment property is likely to increase again and attract more interest from buyers. This is likely to lead to increased liquidity on the transaction market.

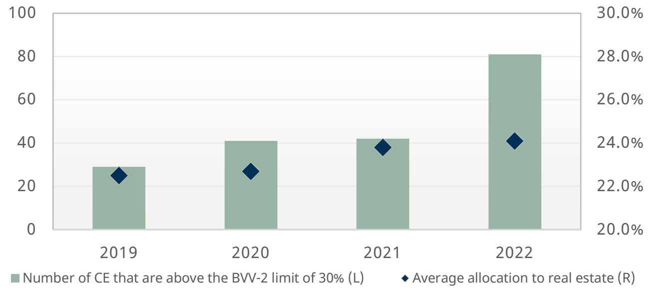
Differentiated price development: Despite a revitalised market dynamic, general price increases are not foreseeable in the near future. Institutional investors, who have supported the buyer side in recent years, could increasingly act as sellers. This is not only due to the adjustment of their property quotas, but also to sustainability requirements (Figure 13). Environmentally conscious portfolio reorganisations are leading to certain properties being sold and more sustainable properties being acquired. Increasing market liquidity opens up the opportunity to sell less suitable properties without large price discounts. However, the increased demand for properties that fulfil the sustainability criteria is likely to lead to higher prices for such properties.

New opportunities: Liquidity could also be accompanied by a certain degree of volatility. Such market conditions create opportunities that could be of interest to attentive investors. In the current market environment, residential property offers a wide range of attractive investment opportunities, from simple buy-to-rent models to construction and promotion through to the realisation of profitable usage concepts.

To summarise, it can be said that the market for residential investment properties offers great potential in 2024. Depending on the individual needs and objectives of investors, the property market opens up a wide range of investment opportunities (Figure 14).

With our expertise and extensive resources at Avobis, we are ideally positioned to offer our customers customised investment opportunities that are optimally tailored to their specific needs and objectives. We look forward to 2024 with confidence and look forward to supporting our clients in realising their investment projects in this promising market.

Figure 13: BVV-2 limit of 30% was exceeded by many pension funds



Note: The regulations for pension funds stipulate that the investment allocation in real estate may not exceed the limit of 30%.
Source: Figure based on PPCmetrics, as at 22/12/2023

Figure 14: The four quadrants of property investment

	Equity capital	Debt capital
Direct	• Directly held properties • Club Deals	• Direct granting of mortgages • Private investment vehicles
Indirect	• Listed and unlisted property funds • Property shares	• Mortgage bonds • Mortgage fund

Source: Own presentation, Avobis, as at 22/12/2023

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Would you like to develop your property sustainably or clarify the development potential in order to ensure a sustainable return? We develop utilisation concepts, scenarios and tailor-made strategies for your sustainable property development.

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The consideration of sustainability aspects in property investments is becoming increasingly important - but there is still a lack of products that meet this demand. We enable you to invest in investment vehicles or build your own customised investment products according to your wishes.

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