Swiss Finance & Property Group Quarterly Newsletter

April 2019

SFP

Swiss Finance & Property Group

EDITORIAL

Very strong Swiss real estate

The market development in the first quarter of 2019 clearly exceeded our optimism. With a performance of almost 10% in the first quarter, the annual target has already been more than met. A solid sideways trend in the coming months must be regarded as a success under the given circumstances. From an economic point of view, this should be possible in principle. Although the SNB has now admitted that interest rates will be positive again sometime in the future, there is hardly any danger from this side. FINMA's warning of the financing risks associated with investment properties will not trigger any violent market movements either, as the relevant market share is far too small. It remains the case that the greatest risks are of a political nature, or if we were to lose our nerve in the event of minor disruptions. In other words, always breathe easy and keep a cool head so that prices may stay where they are.

Joachim Schütz, Chief Economist

CONTENT

BIG PICTURE – EUROPE AND CHINA SUPPORT THE EXPANSION IN THE USA

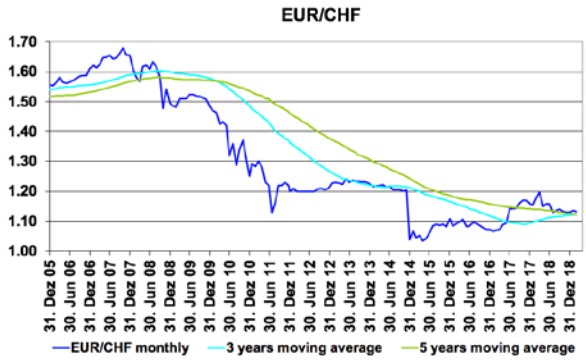
Slowly but surely, the fear of recession in the USA seems to be abating. As well as the uninterrupted expansion in the US labour market, with unemployment figures recently reaching their lowest point in 50 years, the latest data from China indicate that industrial activity in the first quarter of 2019 has once again reached the solid figure of over 6% p.a.

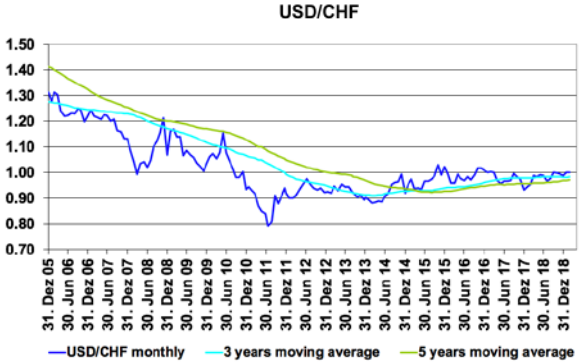
In view of the important role that China holds in the global structure of the supply chain, this indicates that the activities of its upstream and downstream global operations should have been affected as well.

The same can be said for Europe. Although it is clear that the collapse in the capital goods sector, which was triggered by the confusion about the proposed Brexit deal that the British government is trying to achieve as well as the so-called Dieselgate emissions scandal, was somewhat greater than expected, the data regarding the actual edge both in Germany and in the periphery nevertheless indicate that real growth rates will pick up speed once again in the second half of 2019. Overall, it is still possible to see that the economic development in Europe is following almost exactly the same pattern as that of the US recovery, although with a time lag of some three or four years. The main reason for this has to be the excellent performance of the German export industry and the clear reduction in private debt in the southern European countries of the EU. In the meantime, at around 3%, even non-performing-loans have reached a level that finally raises expectations of a slow expansion in the granting of credit and thus an acceleration in the real growth rate.

The significance of this current interlude at international level lies less in material consolidation, given the robust US economy, than in the fact that the pessimistic expectations in the US money and bond market have little credibility in the face of such data. In a first step, efforts will be made to relativise the declining dollar rate expectations of the US Fed and to interpret the current Fed position as being precisely in line with what it announced, namely that it must first wait and see. This will have two consequences. On the one hand, the drastic decline in interest rates since October last year should now be corrected. This will reduce the pressure on the ECB and the SNB, so that the fist interest rate movements upwards in Europe in the course of the year will finally become reality. Whether

Exchange rates EUR/CHF and USD/CHF





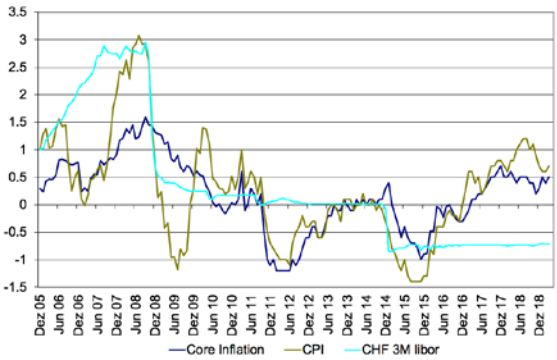
Source: Bloomberg, SNB

this will happen in the final quarter of this year or in the first quarter 2020 is of secondary interest.

In addition, the changed expectations in the economy should then start to synchronise more strongly. This is bound to have a positive impact on the capital goods sector, in particular in Germany and thus also in Switzerland. At the same time, such a positive trend would make way for a revision in the undervaluation of the EUR and the low interest rates. For Switzerland, this would mean that part of the short-term safe-haven-flows could now flow back at last, which would allow the CHF, i.e. the SNB, to correct the "over-valuation" of the CHF in relation to the EUR at the same time and thus also create the space for interest rates to move into more positive realms.

In the above-mentioned scenario, Swiss real estate would initially remain very sought after since the yield advantage of real estate in comparison with long-term government bonds is expected to reduce only slowly. A greater challenge to begin with is expected to be the selectively increased vacancy rate, but even this factor should not present any great threat in the face of the positive development, unless building activity were to completely ignore this factor. It is clear that this scenario offers numerous areas for possible risks, but their low probabilities should not be sufficient to put the brakes on the positive development in any meaningful way.

Core inflation, LIK and CHF 3M Libor



Source: Bloomberg, SNB

Joachim Schütz

INDIRECT REAL ESTATE INVESTMENTS

The market for listed Swiss real estate investments performed strongly overall in the first quarter of 2019. The Swiss listed real estate funds therefore posted returns of +8.5% as measured by their index (SWIIT), and Swiss real estate shares posted returns of +9.0% as measured by their index (REAL).

This strong performance may come as a surprise, but was only to be expected in the context of a previous almost 18-month long consolidation of the prices of these investments and the heavily reduced capital market interest rates in the fourth quarter of 2018.

Thus, upon the weakening of the global economic growth in the last quarter of 2018, the FED implied the need for "more patience" with regard to a future rise in its base rates. With this adjustment to the previously resolute rise in the base rates, the equity markets, i.e. the markets for listed real estate investments, reacted with correspondingly strong price rises in the first quarter of 2019. In the meantime, numerous market participants anticipate a reduction in the US base rates in 2020. We are not of this opinion and anticipate a further increase in these base rates, based on the current US inflation rate of over 2% that is the critical threshold for the FED for interest rate increases. It is only the extent and tempo of the base rate increases that may slacken off in the next couple of years in comparison with the prior years 2017 and 2018, but a change in direction seems highly unlikely to us.

With the signal from the Fed regarding more patience when it comes to further interest rate increases, the global capital market interest rates also deflated somewhat. The interest rates for 10-year US government bonds thus sank from 2.69% to 2.41% in the first quarter. The interest rates for Confederation bonds with this term have continued to sink further into negative figures this quarter, from -0.25% at the beginning of the year to up to -0.43% in March. Correspondingly, investments with higher and comparatively more stable dividend payments are sought after. With a view to the upcoming payment dates for Swiss real estate funds and real estate shares in the first and going into the second quarter 2019, this sector is experiencing additional demand that is expected to last into April. It is only once this first wave of payment deadlines has passed that this demand in the sector is expected to tail off slightly.

In comparison to the capital market interest rates for Confederation bonds, Swiss real estate funds and real estate shares offer record interest margins with direct yields of 2.73% and 3.78% respectively. The premiums paid in comparison with their net asset values of 23.8% seem appropriate compared with their average over the last 12 months of 20.3%, if the renewed sharp decline in interest rates is taken into account. The extreme price fluctuations that can be identified on an individual basis due to increased demand, however, have motivated us to extract the profits from these positions and reposition them in more defensive positions in our investment portfolio for higher operative cash flow returns.

Due to the broad-based demand for the Swiss indirect real estate investment sector, we maintained a comparatively neutral allocation between real estate funds and shares and a modest share of liquid funds, primarily from dividend payments, in the first quarter.

With a view to the second quarter, we identify both macro-economic as well as sector-specific drivers that

could lead to increased price volatility and correspondingly large price falls in listed Swiss real estate funds as well as in real estate shares. On a macro-economic basis, increased uncertainties regarding global economic growth, driven by the trade war in the USA and compounded by the unruly exit of Great Britain from the EU, represent the greatest downside risks for the capital markets. In addition, higher interest rate demands for US government bonds on the part of the market participants could further depress the capital markets. On a sector-specific basis, we anticipate capital increases of up to CHF 370 million in the real estate fund segment in the second quarter, of which approx. CHF 90 million is in listed real estate funds. Finally, it is anticipated that a Swiss real estate fund, Sarasin Good Buildings, will be admitted to the index of listed funds in the first half year following a capital increase and quotation. According to their investments, passive investors will have to restructure to the detriment of the existing funds in the index. We thus anticipate that a consolidation of the strong upward trend since the beginning of the year is probable in the second quarter. Fundamentally, and bearing in mind the latest strategy presentations for collective investment schemes, we observe an increasing differentiation in the type of portfolio development. Whilst one group follows an approach of consolidation and repositioning of property in its portfolio development, a second group gives preference to a growth strategy based on further portfolio acquisitions and building projects. With our focus on the earning trends per share, we identify far better growth opportunities in the first group and have therefore based our investment approach on this.

With a view to the direct real estate market, the strong building activity in the residential sector outside of the metropolises shows an increasing absorption of vacancies as well as growing numbers of vacancies in the old stock. Correspondingly, the quality of the macro situation remains the main focus in the selection and monitoring of collective investments for residential buildings. In the case of new builds, as well as the assessment of the location, the assessment of the building activity in the relevant market area, the structure of the rents vis-à-vis the local market and the assessment of the regional demand for living space are some of the main criteria in our investment decisions.

Finally, for the third year in a row, the International Monetary Fund (IMF) and now also FINMA are warning Swiss real estate investors to adopt a cautious approach with regard to their possible over-indebtedness. FINMA is now demanding that financial institutions should tighten up their requirements for the granting of mortgages, also in the case of the financing of investment properties. In its most recent report in April, the supervisory body stated: “The growth in the volume of mortgage lending has exceeded the growth in economic performance as well as the increase in incomes for some time now. This is one reason why – in relation to its gross domestic product – Switzerland is the country with the highest level of debt per private household worldwide. But the volume of mortgage debt is not just enormously high, it has also risen sharply: in the past 10 years by 45 percent, in the past 15 years by a staggering 100 percent.” If the credit institutions were indeed to tighten up their capital requirements for the financing of investment properties, this would only deter a small part of private investors from the investment property segment that the Swiss collective investments and real estate investment companies are interested in, i.e. generally properties in excess of 10 million francs. The major drivers for further price adjustments within the transactions market continue to be the development of the capital market interest rates and the further assessment of rental yields for these investments.

Nicolas Di Maggio, Head Asset Management indirect investments
Johannes Schwab, Portfolio Manager
Ruedi Göldi, Portfolio Manager

THE RISE OF CO-WORKING

Coworking or flexible workspace enables workers from different organizations to operate in one shared office space, through either memberships or traditional leases. Coworking spaces initially attracted startups, freelancers, entrepreneurs, and remote workers.

However, as the sector continues to develop, coworking operators are targeting larger firms. The movement has spread excessively since the global financial crisis. The number of coworking spaces in the US grew from less than 300 in 2010 to over 4,000 at the end of 2017, resulting in a compound annual growth rate of almost 50%.[1] Outside the US, 200 spaces have increased to 10,000 over the same time period, representing a compound annual growth rate of over 80%.[2] Cushman and Wakefield branded 2018 as the year of the coworking/flexible office sector.

Leasing activity for coworking firms accounted for 18 percent of all office deals in Manhattan in 2018, further accentuating the sector's progression.[3] Additionally, WeWork, a renowned coworking operator, recently became the biggest renter of office space in Manhattan (492,000 sqm.), surpassing JP Morgan (483,000 sqm.).[4] WeWork's valuation is now larger than any office real estate investment trust in the US and it is largely accountable for the coworking sector's increasing stake in office take-up levels.

Coworking share of inventory and growth in the US

	Coworking space share of total office inventory	Coworking space share of total office inventory	Coworking space share of inventory growth
	2016	**Q2 2018**	**% change 2016 – Q2 2018**
Manhattan	1.40%	2.10%	52.90%
Other top 10 markets	0.90%	1.40%	28.30%
Secondary markets (9)	1.10%	1.50%	17.20%
Total, all metros	**1.10%**	**1.60%**	**31.30%**

Source: Colliers International

1. Colliers International. 2019. "U.S. Flexible Workspace And Coworking: Established, Expanding And Evolving."
2. Colliers International ([1])
3. Rizzi, Nicholas. 2019. "NYC Coworking Leasing Activity Climbs 200 Percent Last Year: Report". Commercial Observer. https://commercialobserver.com/2019/01/coworking-leasing-activity-increased-by-200-percent-last-year-report/.
4. Colliers International ([1])

Coworking operators in the US

	Total sqm. leased	Number of sites	Avg. space per site (sqm.)
WeWork	1'130'000	154	7'300
Regus	437'000	224	2'000
Knotel	232'000	120	2'000
Spaces	78'000	29	2'700
Convene	50'000	14	3'500
Industrious	49'000	22	2'200
Level Office	48'000	8	5'900
MakeOffices	40'000	12	3'300
Premier Business Centers	27'000	19	1'400
Jay Suites	24'000	8	3'000
Top 10	2'115'000	610	3'300
Other operators	483'000	301	1'600
Grand total	**2'598'000**	**911**	**2'900**

There are several motives for landlords to include a coworking element in a property. It offers tenants flexibility in the form of short-term leases, the opportunity to scale up or down, and immediate availability. Coworking spaces commonly provide amenities, modern technology and exposure to innovators, start-up communities and creative environments.

As these offerings are desired by millennials, firms may enhance their chances of attracting talent by renting a coworking space. Tenants do not have to pay for fit-out costs up front or all at once, and coworking spaces may also represent a solution for renting out smaller areas in a property that may typically be difficult to fill. Lastly, the higher footfall due to the higher number of workers per square meter can boost ground retail sales of an office property. A competitive labor market, the increase in remote workers and coworking's reputation of enhancing creativity and productivity build a strong case for flexible workspace.[5] WeWork claims that its locations can generate 29% in rent premiums for landlords.[6]

The typical office space is approximately 15 sqm. per person. Coworking operators utilize space efficiently and usually reduce this to about 7 sqm. per person. This higher density comes with considerations for landlords as capital expenditure requirements are significantly higher than for traditional office spaces. Coworking office fit-outs increase wear and tear, energy usage, and security issues. The lower allotted space per person may be concluded as inadequate in the future.

5. Colliers International (1)
6. Wework. https://wework.com/de-DE/landlords.

The sector's perceived downside risk in a financial crisis is an area of concern. In the event of an economic downturn, coworking operators are not expected to display much resilience. Coworking operators are naturally vulnerable in a recession. They possess fixed long-term leases with landlords, yet their own short-term contracts with tenants and members are likely to drop in both price and frequency.[7] Moreover, the business model of short-term leases and a tenant-base predominantly comprised of entrepreneurs and small start-ups appears more volatile in comparison to that of a traditional landlord which has longer leases with more established businesses. On the other hand, a premium might even be created for coworking space if occupiers were to place a high value on flexibility during a downturn.

CBRE recently conducted a study on flexible space's impact on property valuations. The firm analyzed 31 sales transactions of office buildings with at least a 10% coworking occupancy, against 104 peer transactions (comparable geographic proximity, building age, size and quality, date of sale) with no coworking occupancy. The transactions occurred across 13 markets and within the last 5 years. When comparing cap rates for coworking transactions to their peers, only 10% had a lower cap rate, whilst 45% had a cap rate on par with peers and 45% displayed higher cap rates. Furthermore, 64% of buildings with more than 40% coworking space had higher cap rates than their peers, and 67% of buildings with less than 40% coworking traded on par with peers. Thus, a risk premium is currently associated with a higher amount of flexible space at a property. The sample set of the study is, however, limited. If the sector's prevalence continues, a clearer story concerning valuations will arise.[8]

Coworking has swayed the construction and design of the modern workplace, prompting landlords to re-evaluate the dynamics and designs of their office spaces. The sector's evolution and strong growth trajectory over recent years suggest a continuation of development. Nonetheless, time will tell whether WeWork and its fellow operators will prove successful in the long-term.

Image source: https://www.wework.com/de-DE/

7. Colliers International (1)
8. CBRE. 2019. "The Property Value Implications of Flexible Space."

TECHNICAL ANALYSIS

Quelle: Bloomberg

SWIIT Index 1. Quartal 2019

Between October and December, the downside was interrupted twice by the support line at 354 points. A double bottom formation has formed. The following price increase and the closing price above the middle elevation complete this price formation. This development signals a trend reversal. The expected price target of around 14 points (corresponding to the width of the price formation) was reached within one month. This upside, which occurred at the turn of the year, is still active today. During the price trend in the first quarter of 2019, we were only able to observe short-term counter movements. As a rule, these occurred at the level of price peaks from the previous year. The last interruption of the upward trend occurred in mid-March, at the level of the previous all-time high (August 2017). Thanks to the renewed rise in demand, this hurdle was overcome within a short space of time and the SWIIT Index reached new highs. To date, there are no clear signs of a possible trend reversal. A possible reason for an end to the upside could be rising capital demand from the issuing market. At present, this capital requirement is rather modest compared to the previous year. However, if reports of capital increases and new launches accumulate, this could lead to increased selling pressure on the market in the short term.

REAL Index 1. Quartal 2019

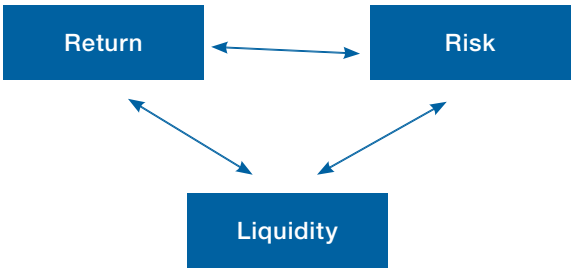
The current upward phase originated in mid-October 2018, when the support line at around 2300 points served as the basis for the trend reversal. During the first weeks after the successful changes of direction, the still young upside was slowed down by resistances in the form of moving average lines. During several weeks these average lines prevented the continuation of the upward phase. The breakthrough was not achieved until January. Despite the positive values of the technical indicators, the continuation of the upward movement was interrupted again by resistances, now at the level of previous price peaks. With this resistance at the upper end and the now price-supporting Moving Average lines at the lower end, the REAL Index traded within a trading range of 2'475 and 2'525 points for about six weeks. Only with a new MACD buy-signal as support the index managed to break through the upper edge of the price formation. Thanks to this event, the upward movement resumed after weeks of interruption. The REAL Index trades at a new all-time high on April 3, 2019. The first counter-tracks after the new highs were intercepted by a former resistance line. If this new support line at the level of 2'565 points is not breached in the coming weeks, the upside remains active. However, a closing price below this level would be a first indication of an imminent trend reversal.

Thomas Marti, Trading

RISK MANAGEMENT DIRECT REAL ESTATE

Due to an obstinately low interest rate environment as well as the continued surplus in demand, real estate prices remain at a high level. Making the right investments is a huge challenge in this market environment. For this reason, correct risk management in the asset management of direct real estate investments takes on a central role.

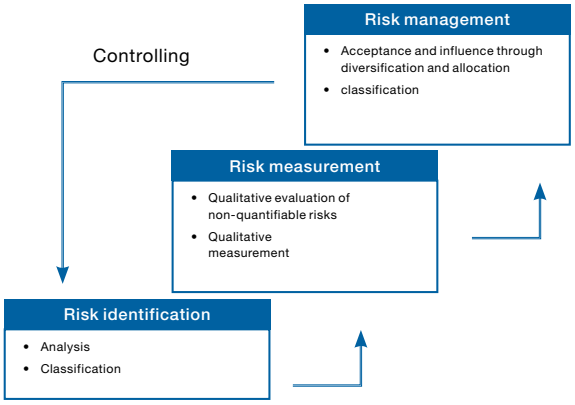
Fundamentally, all investments are associated with certain risks. In this, investors make achieving the greatest yields their aim because their monetary success is fundamentally the most important factor for every investment. In the case of real estate, this is positive cash flow from the interest payments and the increase in value, which together form the overall success. However, the yields cannot be unilaterally maximised at will since this would lead to a disproportionate increase in the associated risks. In the case of an investment, the yield should not be the only point of consideration. A distinction is therefore drawn between three classic aims that together form the magic triangle of investment goals. These three goals are very closely linked to each other because all three goals can never be realised independently of each other. They form the foundation for all investments and/or the examination thereof. As the fourth dimension, the factor Time is depicted in the middle since the investment horizons must also be taken into account in the case of investments.



Magic triangle of investment goals

Source: Own illustration based on Wellner, 2003

Following the investment decision, the risks that have been taken on board must be constantly monitored. This process is firmly anchored in the asset management of the SFP Group. Operational risk management is a continuous process that can be divided into the three fundamental steps of identification, measurement and steering of risks. In this case, risk management does not mean the elimination but the optimisation of the risks that have been taken on.



Risk Management Process

Source: Own illustration based on Wellner, 2003

Risk identification

The first step is risk identification. One important feature is the strategic aspect, which should systematically illustrate the risks that seriously jeopardise the achievement of the strategic goals. Thus, for the listed property fund of the Swiss Finance & Property Group, being able to distribute a sustainably attractive dividend whilst ensuring that the liquidity remains well balanced is of high strategic value. Risk identification is the most important phase in the risk management process since only a known risk can be analysed and steered. For the recognition of possible risks, the risks are collated together in a catalogue and divided into economic, sector-specific and location-specific risks, as well as into object and environment risks.

Risk quantification

Once the risks have been identified, they are evaluated within the framework of the risk quantification on the likelihood of their actually occurring and their quantitative impact. The interactions between the individual risks and their financial impact must be taken into account. An isolated assessment of individual risks is therefore not very meaningful as the relevance of the risks can often only be seen in the overall context. In addition, the duration of the impact of the risks has to be differentiated. This impact can be on a one-off basis or it can last for a long time. Finally, the risks have to be aggregated and the total risk position of the property as well as the relative importance of the individual risks must be determined.

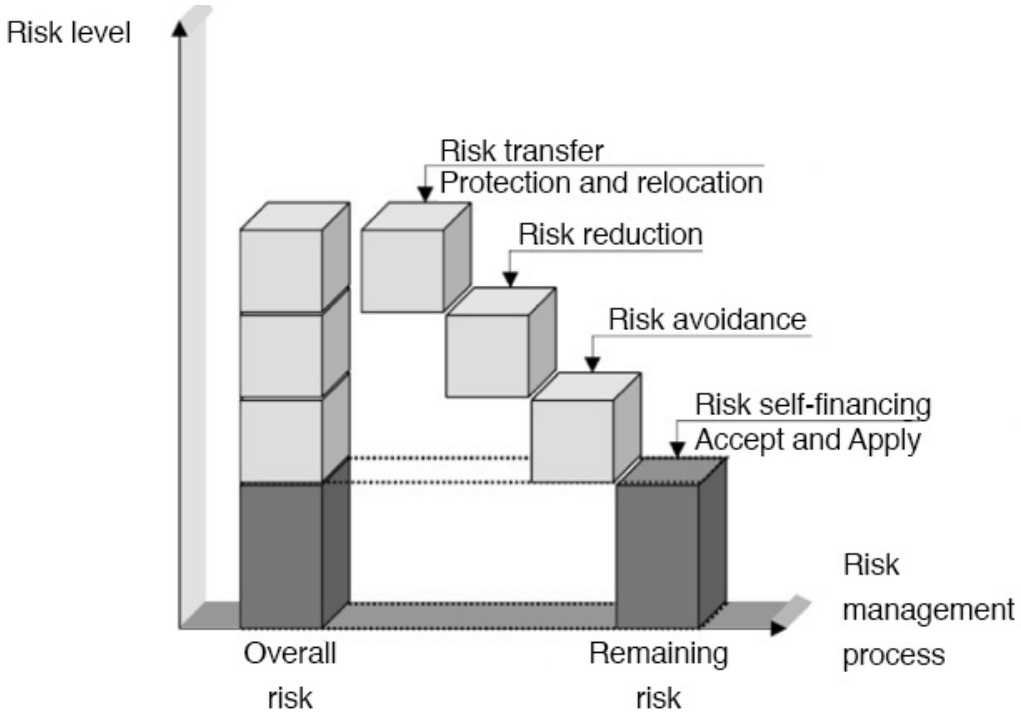
Risk management

In the case of risk management, a distinction is drawn between two main areas:

- The conscious entering into risks in order to achieve higher yields and the management thereof within the framework of the risk management, and
- The deliberate avoidance of risks or the hedging thereof and their transference to other risk carriers.

The decisive factor regarding which strategy is chosen is the relevant risk level in accordance with the following illustration.

Whilst the acceptance of any risks whatsoever is unacceptable in the risk avoidance strategy, i.e. the corresponding investments are simply not made, the likelihood of the risk occurring is reduced in the case of risk minimisation (cause-related risk strategies), or at least the impact thereof is limited (impact-related strategies). In the case of risk shifting, the risks are passed on to third parties, e.g. by concluding the relevant insurance policies. The remaining risks fall under the category of risk retention, whereby the investors consciously decide to bear certain of the risks entered into themselves.



Risk management methods depending on the risk level Source: Wellner, 2003

Key risks housing industry

With relation to the housing industry, six key risks were identified from the risk catalogue. These six key risks are continuously monitored through active asset management and appropriate measures are defined where necessary. Thus, for example, particular attention is paid to the vacancy risk in the SF Sustainable Property Fund. Due to the high level of building activity in the last few years, which is anticipated to continue into the foreseeable future, this risk has increased. In order to counter this risk, appropriate measures are defined at object level in order to be able to place the vacant buildings successfully on the market.

Risk	Risk description	Matter of risk
Sales risk	Re-leasing/sale risks	Kein Markt vorhanden
Earnings risk	Risks from the reduction in economic success	Vacancy, poor creditworthiness of tenants, rents too low
Vacant risk	Risks of vacancy, short- to long-term consequences	High fluctuation, decline in demand, high construction activity
Portfolio risk	Risks arising from the structure of the property portfolio	No diversification, poor condition of properties
Return risk	Non-achievement of return targets	Decreases in earnings, increases in costs, high additional investments
Vermietungs-risiko	Risks of initial or re-letting	Poor condition and equipment, rents too high, excess supply

Risk catalogue for key risks housing industry

Source: Own illustration based on Lechelt (2001)

Currently, and in relation to this, all the properties in the SF Sustainable Property Funds are being analysed in the following five phases within the framework of the quarterly financial statements:

Phase	Topic	Description
1.	Analysis I	• Ongoing evaluation of the Immopac vacancy statistics • Check of the data with regard to completeness/correctness • Definition of the real estate affected
2.	Analysis II	• Discussion re. vacant real estate with manager or Key Account Management (KAM) • Poss. viewing of real estate and all vacant properties • Decision to decrease vacancy rate with management or external marketing mandate
3.	Measures	• Determine measures with manager or KAM per building • Poss. agreement with external marketing agent
4.	Impact assess-ment	• Impact of the marketing measures on the income statement and key figures • Take into account the impact of the measures on the valuation, e.g. reduce target rental
5.	Reporting	• Ongoing check of the marketing measures based on the key figures and the marketing reports • Determine the reporting interval AM, manager/marketing agent • Monthly reports to PM / ExB

Matthias Flückiger

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Swiss Finance & Property Group

EVENTS

SFP INTERNATIONAL FUNDS DAY

18 June 2019 Hotel Savoy Baur en Ville, Zurich Beginning 08.15

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