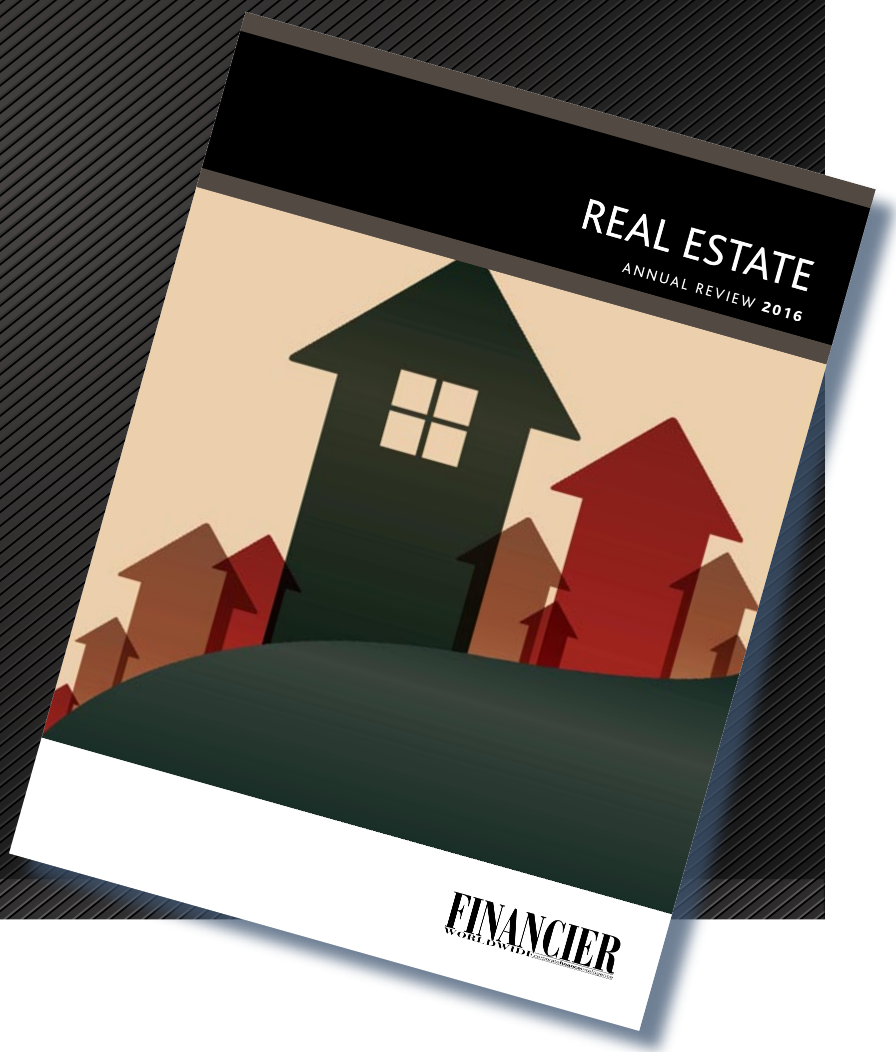
ANNUAL REVIEW

REAL ESTATE



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SWITZERLAND

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Q COULD YOU OUTLINE SOME OF THE MAJOR TRENDS IN THE REAL ESTATE SPACE IN SWITZERLAND OVER THE LAST 12-18 MONTHS?

BRUNNER: To start, we would make two introductory remarks. First, the acquisition of residential real property in Switzerland is restricted for foreign individuals and companies, although exceptions apply, such as for citizens of the European Union. There are no restrictions with respect to commercial real estate property. Second, Switzerland's real estate market is very segmented, with regional peculiarities playing an important role when deciding on investing in real estate. Real estate segments in Switzerland develop very differently. On the one hand, we have seen substantial investments by real estate developers and institutional investors in residential property – both owner-occupied and rental, in particular higher density complexes. With respect to office space, we note that rental demand is lower than supply, resulting in rather attractive conditions for potential lessees in terms of reduced rates and flexibility in rental terms. Retail space faces difficulties due to increased competition from online shops as well as an unfavourable CHF/EUR exchange rate, which makes it very attractive to shop abroad. One exception in the retail space is convenience stores.

Q WHAT PARTICULAR RISKS AND CHALLENGES ARE REAL ESTATE PLAYERS FACING IN TODAY'S MARKET? HOW ARE THESE FACTORS IMPACTING STRATEGIES?

BRUNNER: We would point to three specific challenges. Firstly, the recent vote on restricting immigration created uncertainties for companies that depend on employing foreigners. These uncertainties may result in Switzerland becoming a less attractive place to do business. If there are fewer ex-pats and high income employees, demand for mid to high priced residential properties, where currently significant investment takes place, may stagnate. In addition, the demand for office property may continue to decrease and stagnation may be further accelerated by large companies outsourcing or moving administrative and back-office functions to lower-wage countries. Secondly, other uncertainties relate to corporate taxation. The EU and the OECD voiced criticism at the tax privileges Switzerland grants to certain foreign entities, which led the

federal government to propose a reform package on corporate taxation which is currently being debated in parliament. Until its implementation, however, foreign companies may hold back investments in Switzerland or make investments elsewhere, which in turn may have negative effects on real estate markets, both commercial and residential. Finally, the Swiss real estate market, which has been expanding for the last 15 years, is considered to create more and more of a risk and the Swiss real estate 'bubble risk' index – composed by UBS for many years – reached its highest level at the end of 2015. In light of such developments, there is an increasing risk for government intervention. Banks have already been obliged to introduce stronger capital requirements for financing owner-occupied housing and the bank regulator has started to closely watch the investment properties market and consider the option to tighten financing conditions.

Q WHAT FACTORS ARE DRIVING REAL ESTATE M&A AND INVESTMENT IN TODAY'S MARKET? ARE THERE ANY SEGMENTS OR REGIONS THAT SEEM TO BE OFFERING A WEALTH OF OPPORTUNITIES?

BRUNNER: Investments in real estate are primarily driven by institutional investors, namely insurance companies and pension funds, seeking assets with positive cash flows and higher yields given that fixed income investments are currently less attractive due to historically low interest rates. This situation is accentuated by the Swiss national bank currently charging negative interest on deposit accounts, which led many institutional investors to reduce liquidity and investments in real estate. At present, considerable investments take place in mid to higher income residential properties, but studies show that the risk of oversupply may increase due to factors such as stagnating immigration from high-income countries, uncertainties with respect to the planned corporate taxation reform, among others.

Q IN BROAD TERMS, HOW WOULD YOU DESCRIBE CURRENT VALUATIONS FOR REAL ESTATE ASSETS IN SWITZERLAND? IS THERE A GAP BETWEEN BUYER AND SELLER PRICE EXPECTATIONS IN THE CURRENT MARKET?

BRUNNER: Switzerland has experienced a booming real estate market in recent years as low interest rates on mortgages have substantially driven up demand. Prices are still relatively high, although corrections have taken place in some regions. The hotspots in Switzerland are Zurich and the lake of Geneva region, which are considered overvalued. The eastern part of Switzerland should also be monitored, according to the UBS Swiss real estate bubble index. On the investor side, low interest rates are a key element – on the one hand, institutional investors are forced into the real estate market due to a lack of viable investment alternatives in the fixed income segment; accordingly, they are ready to accept low yield investments, which translates into a willingness to pay high prices for prime real estate that guarantees a good and secure rental income stream. On the other hand, investors who could not refinance at such low interest rates as currently available on the market may face a competitive disadvantages in real estate bidding, since their internal capital costs may not allow them to bid as high as market expectations.

Q MANAGING RISK AND IDENTIFYING VALUE ARE FUNDAMENTAL PARTS OF THE ACQUISITION AND INVESTMENT PROCESS. IN YOUR EXPERIENCE, IS ENOUGH DUE DILIGENCE BEING CONDUCTED IN TODAY'S REAL ESTATE DEALS?

BRUNNER: This is quite difficult to assess. Investments are largely driven by historically low interest rates. As long as interest rates remain low, investments in residential rental complexes, for example, will likely remain attractive. However, increasing interest rates may not necessarily be compensated by higher rental rates due to the competitive environment, as well as statutory restrictions. As to the latter, rental rates are pegged to a government-set reference interest rate. This reference interest rate is re-evaluated by the federal government every three months. With regard to existing apartments, rent may only be increased if reductions in the reference interest rate have been passed on to tenants in the past, or if renovations have been made resulting in an increase in the value of the apartment. While investments still focus on mid to higher income properties, studies expect demand for rental apartments to remain stable in quantitative terms; however, it may change in terms of quality due to demographic developments. Hence, investments should be carefully analysed with respect to such demographic developments.

"Institutional investors are forced into the real estate market due to a lack of viable investment alternatives in the fixed income segment."

Q WHAT KINDS OF TRANSACTION STRUCTURES AND INVESTMENT VEHICLES ARE REAL ESTATE PLAYERS USING TO EXECUTE DEALS AND OPTIMISE THEIR LONG-TERM RETURNS?

BRUNNER: Indirect investments normally occur through real estate funds and stocks. Alternatively, investors use tailor-made SPVs, either domestic corporations limited by shares or limited liability companies or foreign entities from countries which maintain double taxation agreements with Switzerland. Real estate investment trusts provide no tax advantages in Switzerland and are therefore not used.

Q WHAT ISSUES AND DEVELOPMENTS DO YOU BELIEVE WILL SHAPE THE REAL ESTATE MARKET IN SWITZERLAND OVER THE MONTHS AND YEARS AHEAD?

BRUNNER: Switzerland has experienced booming real estate markets in the past, but the returns seen in the past are unlikely to be repeated in the near future. With interest rates still at a historically low, as well as the Swiss national bank charging negative interest rates, investments in real estate by institutional investors such as pension funds and insurance companies is likely to continue at a high level. Another aspect that should be considered is how the federal government will implement the mass immigration vote and the corporate tax reform. These are variables with ambivalent ramifications.

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Hans-Ulrich Brunner is head of the Real Estate & Construction team at Prager Dreifuss Ltd. He advises and represents individual and corporate clients in corporate and commercial matters. He has a special focus on, and longstanding experience with, real estate transactions, construction business operations and design practices. In addition, he regularly acts as defence counsel in liability and insurance cases.

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