Fragile stabilization

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Swiss office property market 2018: Management Summary

A lengthy period of low interest rates has obliged the Swiss office property market to deal with an increasing stock of new office space during years of sluggish demand. This has created an oversupply and rising vacancies, particularly in the large office markets. Meanwhile, the market appears close to bottoming out. But what is the real state of the market?

Fragile stabilization in the market for office space
Thanks to an acceleration in Swiss economic growth, we expect to see a revival in demand for office space in 2018. However, the pace will likely be slow, since the employment trend lags the economic cycle. In an environment where everything seems to be in flux, companies are hesitant to take on great numbers of new staff. Meanwhile, on the supply side, a substantial expansion is on the cards for the medium term, since project planning activity has risen well above the long-term average. In Basel, Bern and Lausanne, though, the office market should continue to recover with time. The oversupply, if any, is limited to the outer business districts of these markets. In the two largest office markets of Zurich and Geneva, however, more time is needed for the market to find a floor and marketing in all segments will probably remain challenging for several more quarters. Vacancies are on the rise, especially on the periphery of the office markets. Since long-standing empty office space tends to disappear from the observation radar, or is re-advertised in smaller parcels, the situation in these markets is actually more tenuous than it seems.

The largest office markets in Switzerland at a glance
Around 44% of all Swiss office space is located in five major centers: Zurich, Geneva, Bern, Basel and Lausanne. Including the 16 mid-sized centers that have at least 350'000 m² of office space raises the figure to 65% of the entire Swiss inventory. These cities provide central functions for their regions and host a disproportionate number of service industries.

Trends in the office markets of the major centers are anything but synchronous
Depending on their size, sector mix, locational quality and investment dynamic, the individual office markets of Switzerland are in various phases of the business cycle. In Zurich, we find that the stock of office space is growing almost imperceptibly, because the long-vacant properties that often disappear completely from online marketplaces, or reappear only in part, are no longer included in the inventory of vacancies. The approaching completion of several major projects will sustain the pressure on the supply side of Switzerland’s largest office market, and boost vacancies, especially outside the city limits. In Geneva, the supply rate has at least stopped rising. Near term, however, weak demand is hampering a quick reduction in the oversupply. Bern remains preoccupied with the absorption of vacancies in its inventory that resulted from the latest wave of expansion. Given the less robust demand, this is likely to be a lengthy process, but the next expansion phase is already on the horizon. In Basel, the core office market is intact, and even shows signs of scarcity in certain market segments. Towards the end of the decade, a significant addition of office space should tangibly ease this shortage. Lausanne is in a similar position. In the core office market, larger and modern office space is hard to find. New office space will only be produced to ease the situation in the medium term.

Mid-sized centers – new horizons for office property investors
The office markets in mid-sized centers have a different profile than those in the major centers, and they bring new qualities to the table. Because of their smaller size and the lower availability of properties, these markets cannot replace investments in the sought-after prime segment of major centers. Nonetheless, the diversification potential they offer based on the variety of their economic structures, a better geographical distribution and lower competitive pressure argues in favor a higher weighting of these markets in professional investors’ real estate portfolios. Depending on the mid-sized center, factors such as low costs, an interesting sector mix, an attractive labor pool or any combination of the above can be motivating for a selection.

Gradual recovery in Bern, Basel and Lausanne – sluggish situation in Zurich and Geneva
Despite a gradual recovery in the office property market, the situation remains fragile and vulnerable to shocks. The marketing situation will remain challenging, especially in Zurich and Geneva.
Overview of the office property market

Fragile stabilization

About five years ago, the Swiss office property market began showing signs of a substantial supply-demand imbalance. This triggered a downturn that in most local markets resulted in rising vacancies and corrections in rent prices. At the moment, although the marketing situation remains highly challenging, the latest data suggest a mild improvement in market conditions. Early signs of stabilization have strengthened over the course of the year. Still, the stabilization can only be considered fragile, because neither rent price data nor supply rates, which raised hopes when they came in somewhat higher than expected, reflect the whole truth. For example, we note that in light of the growing oversupply, certain office spaces are either no longer advertised at all, or only in part. If we take this practice into consideration, the picture (specifically in the largest markets) is no longer quite so rosy. Moreover, low financing costs, attractive yield spreads and a lack of investment alternatives ensure that investments in office property remain very attractive. So, after two relatively quiet years, an acceleration in project planning for new offices is already observable. Given the persistently high supply level and only moderate demand stimulus, these new capital inflows represent a threat to the fragile stabilization of the Swiss office property market. Hopes therefore rest entirely on a gradual recovery of the Swiss economy in 2018, that is expected to stimulate demand for office space.

Demand likely to pick up in 2018

The Swiss economy is gradually fighting its way back to its old growth track. After a stubborn downturn, recent indicators paint a more optimistic picture. Consumer sentiment is unusually good, industrial capacity utilization has been increasing for months, tourism figures are rising, and even retail sales have stabilized for the time being. Meanwhile, leading indicators such as the purchasing managers index (PMI) have climbed to their highest levels in quite some time. Nonetheless, jobs growth is stagnant: after zero net job creation in 2016, the number of workers rose only slightly in the first half of 2017, increasing 0.2% compared to the previous year (cf. fig. 1). Companies are apparently cautious about recruiting new staff – despite healthy capacity utilization and full order books. They are primarily concerned with rebuilding their earnings situation. Many firms have countered the strength of the Swiss franc and the economic clouds in the recent past by accepting narrower margins rather than laying off staff. Now repairing the margins has high priority. Nonetheless, the number of open positions, which had risen 10.5% in the first half of the year and is now at its highest level since the beginning of 2014, gives reason for confidence.

The gap between the manufacturing and service sectors still exists: while employment increased by 0.4% in the service sector, in manufacturing it declined by 0.4%. Compared to the previous quarters, however, the downturn in manufacturing has decelerated, which contributed to the brighter employment situation. The decline in manufacturing employment does not automatically indicate lower demand for office space, since at the same time the share of office workspace in manufacturing is continuously increasing. Services are also gaining significance within industrial businesses. Manufacturing companies increasingly sell not only their machines and systems, but also their flexible use as a service. One result of Industry 4.0 is that more and more services can accompany the delivery of goods in the form of apps, online services for products, digital analysis of production processes and information exchange with customers. The more activities of a service nature offered by manufacturers, and the greater their share of value creation, the more office workspace will be required by manufacturing firms. This trend, which can be summarized in the term tertiarization, has broadened demand for offices in recent years. Our calculations indicate that the percentage of office jobs in the secondary sector rose steadily from 32% to 34% between 2010 and 2015. As a result, despite a decline in employment, manufacturing actually hosts more office jobs now than it did in 2010. Specifically, over the five-year observation period, around 9000 jobs disappeared from the manufacturing sector. Nonetheless, manufacturing has over 13’000 more office jobs today. Demand for office space from the secondary sector has thus increased, on balance, despite the decrease in employment.

Depending on the economic segment, tertiarization may be proceeding more quickly or more slowly. In the traditional manufacturing businesses, for example, the percentage of office workplaces, which was already relatively high at 38.4% in the past, has risen further to 41.4%.
And in the wholesale and retail trade, the share has jumped from 39.3% to 45.9%. On the other hand, the increase in the construction industry was relatively modest (from 14.3% to 15.8%). The approaching digitalization of the construction industry is bound to lift this percentage. Within the service sector there are also shifts in the concentration of office workplaces. In the financial industry, where the figure of 95.5% represents the highest percentage of office jobs with virtually no upside potential, the increase from 2010 to 2015 was a mere 0.5%. On the other hand, the share of office workers in the education and training segment climbed from 32.8% to 37.0%.

Employment increased by 1.0% in the traditional office sectors in the first half of 2017. The highest growth was registered by the insurance industry and corporate services (cf. fig. 1). The latter is likely to have benefited from the tertiarization process in manufacturing, since service providers are increasingly becoming upstream suppliers for manufacturers. The structural changes now wrecking the financial business have a more substantial impact on employment. Banks have cut staff by 1.6% over the last year. The main drivers of this phenomenon are digitalization, contracting margins and rising regulatory costs. And the number of banks in Switzerland fell further from 267 to 262 in 2016. Before the financial crisis there were more than 330. Due to the high concentration of office work in the financial industry, a reduction in employment in this business has more serious consequences for the office market than cuts in any other sector. Consequently, net demand for office workplaces has fallen. At the same time, due to branch closures, additional space has become available in the best locations in the market, which was previously used for consulting services. The reduction in the branch network is picking up speed. In 2016, a total of 97 bank branches were closed. The closure rate has accelerated to 3.4% p.a. over the last few years, after figures of less than 1% in the years immediately following the outbreak of the financial crisis.

The IT sector, which had posted the most considerable growth in the last five years, saw employment drop by 1.3% over the last 12 months. This growth dip should be only temporary, since IT firms profit from increasing digitalization and Switzerland offers ideal conditions for such companies. This is evidenced by, for example, Google’s extensive expansion at its Zurich location. A modern educational system and investments in research and development (R&D) are vital preconditions for mastering digitalization technologies. In some disciplines (e.g. artificial intelligence), Switzerland already ranks among the leading nations for research. Even the financial industry could be a beneficiary in the longer term: Switzerland has great potential as an innovation driver in the fintech business. This is due to, among other things, the presence of globally active financial institutions and the quality of the relevant infrastructure.

In order to attract and retain companies, economic conditions must be assured for the long term. Despite voters’ clear rejection of Corporate Tax Reform III (CTR III), confidence in Switzerland as a corporate location seems to be gradually reviving. In 2016, 265 companies established a presence in Switzerland, most often in the life sciences (23%) and IT/communications technology (20%) businesses. This is the first year since 2007 that the number of registered new companies has not fallen – indeed, the figure rose slightly. As for tax reform, federal authorities and parliament swiftly
Demand for office space likely to pick up in 2018

Swiss economic growth should accelerate markedly in 2018. An improving earnings situation is likely to encourage companies to increase their investment activity, which would stimulate job creation. After only feeble momentum in 2016 and 2017, additional demand for office space should reach the respectable level of 300,000 m² in 2018 (cf. fig. 2). As in the past, the healthcare sector and public services should make a significant contribution (50%) to this positive momentum. The gradual recovery in manufacturing, which is underpinned by the depreciation of the Swiss franc, combined with the increasing tertiarization of this sector, should also generate additional demand for office space. Stimulus from growth segments in the corporate services sector, as well as the largely stable insurance business, should more than compensate for the anemic banking segment, which continues to suffer from the adverse effects of structural change.

Supply: elevated project planning activity

Despite the difficult marketing situation, substantial capital flows are still making their way into the Swiss office property market. In an environment of persistently low interest rates, low financing costs and limited investment alternatives, developing office space remains attractive – both as an investment and for companies’ own use. Last September, the 12-month total of all approved new building projects in Switzerland was 18% or CHF 350 million higher than the long-term average of CHF 2 billion (cf. fig. 3). The latest rise in planning activity is mainly due to the CHF 550 million project Roche Building 2, which was approved this summer in Basel. Before, the volume of approved construction permits in the major centers had been below the long-term average since autumn 2013. However, since sluggish demand has delayed the realization of many previous developments, the dip in project planning activity in the major cities will only become noticeable gradually.

Focus of planning activity most recently on the large mid-sized centers

In the six largest mid-sized centers (Winterthur, Lucerne, Zug, Aarau, St. Gallen, Lugano), on the other hand, project planning activity has resembled a mirror image. This group absorbs an investment volume that averages about one third of the capital flows into the major centers. However, over the last seven years or so, the volume of approved construction permits in these large mid-sized centers was usually higher. Only recently has the volume slipped significantly below its long-term average. The remaining small and mid-sized centers similarly recorded above-average project planning activity after 2010, but this had already edged back again a good two years ago. Submissions of planning applications, which predict development activity even earlier than building permits, indicate that production of office space should remain at a relatively high level across Switzerland. The volume of planning applications is currently above the average level, not only for new construction but also for conversions (cf. fig. 3). The necessity of remaining competitive in a market characterized by cut-throat competition is forcing many owners to renovate their inventory buildings.

Supply level generally appears too low

The volume of office space listed for lease online remains above the 2 million m² threshold. The 0.4% dip over the last year can hardly be considered a tangible decline (cf. fig. 4). Interestingly, large and long-standing vacancies tend to disappear from the online marketplaces after a certain amount of time. This is probably due less to the cost of advertisement than to the lack of interest in these offices, as well as the danger of being labeled a shelf-warmer. Such offices are increasingly being marketed on individual project websites or on real estate companies’ sites. And another pattern is discernible: often only a portion of the available office space will be listed, because it is particularly difficult to find tenants for large spaces of more than 2000 m². The greater the oversupply on a local market, the more likely this phenomenon is to appear. This is
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Currently most evident on Zurich’s office market. In Zurich Nord, for example, only 51% of a total of 144,000 m² available space is currently listed on the online marketplaces.

Due to the above-mentioned effects, the amount of office space advertised for lease has declined only slightly over the past year. At the moment, around 2.3 million m² are offered across Switzerland, which corresponds to a supply rate of 4.3%. The mild decline in available space from a year earlier is principally due to the temporary lull in project volumes approved for construction from mid-2013 to mid-2015. Especially in Lausanne, Geneva and Bern, as well as in the city of Basel, volumes of advertised space are falling. This is not the case in Zurich. It appears that the supply of office space has fallen sharply in the extended business districts that have sprung up around the expensive Central Business District (CBD). The situation is comparable in a few central business districts (CBD Bern and CBD Lausanne). The opposite is true for the in some cases extensive outer business districts. There, the supply of office space is in a continuous rise.

The effects of years of overly high development activity on the perimeters of the office markets are increasingly evident in the form of a burgeoning supply of office space and rising vacancies. Some mild easing is apparent in the supply situation, where space advertised for lease outside the office markets of the major centers declined by –3.0%. On balance, the supply outside the major centers accounts for less than 40% of the total, which is not much from a long-term perspective. Across the entire office market, we expect to see a further decline in advertised office space in the short term, since demand is forecast to pick up a bit and the higher planning activity has yet to be realized. In the medium term, the supply of office space is likely to stay at a disproportionately high level of around 2 million m². The marketing situation for office space will thus remain challenging in the years ahead.

Market results: signs of mild easing

While there are few indicators of a lasting reduction in the oversupply on the office markets, we nonetheless see signs of a mild easing in the market situation. The average amount of time that an object is advertised, for example, is growing gradually shorter. The official vacancy data for 2017, which is drawn from around 43% of Switzerland’s office market, show a slight dip in vacancies after five consecutive instances of increases. However, since the vacancies measured by the statistical authorities are concentrated in the major markets, and in some cases only in the inner business districts, the situation on the periphery of the office markets is not adequately represented. It is precisely here where vacancies are increasing. Nonetheless, vacancy data do confirm the brightening situation in the inner business districts and in the supply of office space.

Total reported vacant office space declined by nearly 7% year-on-year (cf. fig. 5). The core cities of the major centers, in particular, showed vacancies decreasing – by around 7% to 9% in the cities of Geneva, Zurich and Bern, and by a remarkable near 30% in the city of Lausanne. Only in
In recent years, the rent prices observed in lease contracts have also fallen (cf. fig. 6). Since the end of 2012 and 2013, rent prices in the two most expensive markets, Geneva and Zurich, have fallen by nearly 10%, and in the other major centers by 2% to 6%.
Switzerland's largest office markets

Figure 7 summarizes developments on the largest Swiss office markets. Over 65% of all office space in Switzerland can be found in these top 21 markets. The supply is especially concentrated on the five major centers, which together accounted for more than 60% of office space available for lease on the Swiss market in the third quarter of 2017. Combined with the largest mid-sized centers listed below, they account for 76% of advertised office stock. The supply rate for all of Switzerland is 4.3% of the inventory, practically unchanged against the previous year. The future expansion should gain momentum in the major centers in the medium term, while a majority of the mid-sized centers should experience a deceleration in production of new offices.

Figure 7: Existing and advertised office space in the largest office property markets
Total and advertised office space (existing and new constructions) in m² per Q3 2017, area-weighted average rents (net) in 2017 in CHF/m², expected expansion and price trend for 2018

<table>
<thead>
<tr>
<th>Major centers</th>
<th>Total office space</th>
<th>Available office space</th>
<th>Supply rate</th>
<th>Forecast expansion</th>
<th>Average rent</th>
<th>Price trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zurich</td>
<td>10'200'000</td>
<td>705'000</td>
<td>6.9%</td>
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<td>305</td>
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<td>Geneva</td>
<td>4'071'000</td>
<td>303'500</td>
<td>7.5%</td>
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<td>394</td>
<td></td>
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<td>Bern</td>
<td>3'446'000</td>
<td>117'200</td>
<td>3.4%</td>
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<td>245</td>
<td></td>
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<tr>
<td>Basel</td>
<td>3'238'000</td>
<td>142'200</td>
<td>4.4%</td>
<td></td>
<td>209</td>
<td></td>
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<tr>
<td>Lausanne</td>
<td>2'590'000</td>
<td>133'500</td>
<td>5.2%</td>
<td></td>
<td>241</td>
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</table>

<table>
<thead>
<tr>
<th>Mid-sized centers</th>
<th>Total office space</th>
<th>Available office space</th>
<th>Supply rate</th>
<th>Forecast expansion</th>
<th>Average rent</th>
<th>Price trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lucerne</td>
<td>1'527'000</td>
<td>62'200</td>
<td>4.1%</td>
<td></td>
<td>216</td>
<td></td>
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<tr>
<td>St. Gallen</td>
<td>1'299'000</td>
<td>35'800</td>
<td>2.8%</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Zug</td>
<td>1'283'000</td>
<td>57'700</td>
<td>4.5%</td>
<td></td>
<td>238</td>
<td></td>
</tr>
<tr>
<td>Lugano</td>
<td>1'132'000</td>
<td>42'200</td>
<td>3.7%</td>
<td></td>
<td>253</td>
<td></td>
</tr>
<tr>
<td>Winterthur</td>
<td>835'000</td>
<td>19'900</td>
<td>2.4%</td>
<td></td>
<td>224</td>
<td></td>
</tr>
<tr>
<td>Fribourg</td>
<td>639'000</td>
<td>15'600</td>
<td>2.4%</td>
<td></td>
<td>212</td>
<td></td>
</tr>
<tr>
<td>Aarau</td>
<td>600'000</td>
<td>14'700</td>
<td>2.5%</td>
<td></td>
<td>188</td>
<td></td>
</tr>
<tr>
<td>Biel</td>
<td>515'000</td>
<td>11'700</td>
<td>2.3%</td>
<td></td>
<td>170</td>
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</tr>
<tr>
<td>Baden</td>
<td>509'000</td>
<td>14'600</td>
<td>2.9%</td>
<td></td>
<td>190</td>
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<tr>
<td>Neuchâtel</td>
<td>496'000</td>
<td>8'900</td>
<td>1.8%</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Sion</td>
<td>421'000</td>
<td>5'400</td>
<td>1.3%</td>
<td></td>
<td>215</td>
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<tr>
<td>Solothurn</td>
<td>409'000</td>
<td>10'300</td>
<td>2.5%</td>
<td></td>
<td>167</td>
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</tr>
<tr>
<td>Chur</td>
<td>388'000</td>
<td>6'400</td>
<td>1.6%</td>
<td></td>
<td>186</td>
<td></td>
</tr>
<tr>
<td>Schaffhausen</td>
<td>370'000</td>
<td>16'600</td>
<td>4.5%</td>
<td></td>
<td>172</td>
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</tr>
<tr>
<td>Thun</td>
<td>364'000</td>
<td>10'700</td>
<td>2.9%</td>
<td></td>
<td>173</td>
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</tr>
<tr>
<td>Olten</td>
<td>360'000</td>
<td>5'700</td>
<td>1.6%</td>
<td></td>
<td>172</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>53'298'000</td>
<td>2'277'000</td>
<td>4.3%</td>
<td></td>
<td>260</td>
<td></td>
</tr>
</tbody>
</table>

Source: Meta-Sys AG, Credit Suisse
In Zurich’s office market, the supply concentration is high where new office projects are planned or there is an increasing number of vacant properties. The construction projects at the Altstetten and Oerlikon train stations are plainly visible, as are the GreenCity development in the south and The Circle in the north (cf. fig. 8). Vacant properties can still be found in the Central Business District (CBD) of Zurich, where some office space is listed for lease in Enge, a tony lakeside neighborhood, and in the area northwest of Paradeplatz. It is interesting to note where there is little or no office space listed. Despite the in some cases high inventory of offices, re-leasing appears to be functioning well in locations such as Europaallee, Seefeld and Zurich Süd, where existing offices in Binz, around Giesshübel and on Brandschenkestrasse can be leased fairly easily. The Hardbrücke hub has also been doing well for some time. In contrast, successful leases around Glattpark in Opfikon can be counted on one hand. The full occupancy of the Lilienthal building and partial lease of Ambassador House are faced by a long list of properties that have been tenant-less for years.

As a result of the large advertised stock of offices in Zurich and the unsuccessful marketing of a great deal of office space, many objects are no longer being advertised on the relevant platforms at all. In this way, the agents hope to avoid the stigma of a shelf-warmer. However, these objects have not disappeared from the market altogether, as can be found on the individual websites of existing office buildings and development plans. From time to time, a new advertisement may be ventured online with a new agent, or only portions of the available space may be advertised, since at present it is particularly difficult to lease large spaces of 2000 m² or more. As a result, the full extent of the existing oversupply is not obvious. If we include the office space advertised elsewhere than online portals, the volume of space offered has not fallen in recent quarters, as claimed by many market observers, but has actually risen continuously. Swiss Re’s transfer of workplaces to Mythenquai in Zurich and the subsequent advertisement of the vacated premises in Adliswil caused available office space to rocket to over 705,000 m² (cf. fig. 10). This corresponds to a supply rate of 6.9%. Similar consolidation for optimizing purposes is planned, such as Amstein + Walthert’s relocation to the Andreasturm that is under construction, or have already taken place, such as Ringier’s move into the Medienpark or ISS’s into the Cube of the Westlink Ensemble. These moves leave behind difficult marketing situations and vacancies in the previous premises. Sluggish demand is apparently insufficient to fully absorb the newly available office space, especially since renovated office space that had temporarily fallen off the radar recently came back onto the market.
The anticipated acceleration in Swiss economic growth in 2018 should also have a positive effect on demand for office space in Zurich. After stagnating in 2016 and 2017, additional demand should climb to around 25'000 m² in 2018, which corresponds to nearly 0.25% of current supply. Growth prospects in the corporate services and IT sectors, which are well represented in Zurich’s economic structure, are above average and should contribute to this modestly positive development. In contrast, the situation in the banking sector, a very important customer for office space, is likely to remain tense in the years ahead. Structural changes for the main tenants of expensive, central locations will continue to weigh on demand in the CBD in the coming quarters. Premises vacated by the banks Coutts and Leumi, for example, have pushed the available space in the CBD back up to 148'000 m² (cf. fig. 10). Moreover, the lack of clarity on corporate tax reform suggests that there is little hope of a strong revival soon.

The official survey of vacant offices in the city of Zurich showing that vacancies decreased for the third consecutive time should thus be interpreted as a fragile stabilization of Zurich’s office market, not a trend reversal. In a year-on-year comparison, reported vacant office space fell by 18'600 m² to 174'000 m². Certain locations have dropped out of the statistics not because they were successfully leased, but because owners, faced with the impossibility of finding tenants for existing buildings, have opted to rebuild. Rising vacancies in the relatively less accessible Seebach neighborhood suggest that marketing is particularly challenging in the outer business districts. Even in outstanding locations, new offices are slow to move, as is evident in the occupancy rate for the two office towers at the Oerlikon train station. Lease contracts do not provide clear indications of the trend in rent prices. According to Wüest Partner, the negative trend in rent prices was stopped this year. However, market rents from Fahrländer Partner show a different picture, with rents declining by more than 10% over the last four quarters. The GreenCity project illustrates the difficulty of marketing objects on urban perimeters. Instead of the planned office space, other uses are being considered. The Ingres building, for example, may house student accommodation.

Since it is easier to lease new space, offices will continue to be built – at least as long as the environment of negative interest rates persists. Although the volume of approved construction permits on Zurich’s office market has fallen tangibly since mid-2014, it has yet to register a decline on the same scale as the 1990s or after the surge in construction around the turn of the century (cf. fig. 9). Since demand has been so sluggish, the large-scale expansion that was approved between 2007 and 2014 has been realized only slowly. Thus it should be some time before the reduced planning activity works through to a smaller stock. Some projects are still awaiting realization. Developments such as Prime2, Serliana, Orion, Manufakt8048, ps and YOND would bring another 100'000 m² onto the market. Absorption of all this space will take quite some time.
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Figure 11: Supply concentration of office space
Office space (existing and new buildings) listed on the internet for lease in m² per hectare, as of Q3 2017

The concentration of advertised office space in the Central Business District (CBD) is more pronounced in Geneva than in any other major city in Switzerland. Nearly one third of available space in the entire region is listed in the core office market, due largely to the staff cuts carried out by the typical tenants of such expensive locations – banks and commodity trading companies (cf. fig. 11). While foreign banks, in particular, have left Geneva, and thus Switzerland, other banks have fled the city center in search of more modern offices with better value for money. More than a decade after Geneva private bank Pictet moved its headquarters to the outlying neighborhood Les Acacias, rival Lombard Odier has now announced a similar move. Unlike Pictet, Lombard Odier is leaving the city of Geneva altogether, and has plans to construct its own purpose-built headquarters with 1500 employees in Geneva suburb Bellevue by 2022. This strategic optimization will probably free up office space in five of the bank’s current six locations scattered across the Geneva market. Only the office on Rue de la Corraterie will be maintained. To date, law firms have often moved into available space in the CBD.

Since the end of 2016, the high volume of available space in the CBD has barely declined. Over the same period, the supply in Geneva’s extended business district has fallen by 12’000 m². In this zone, advertisements for office space are dominated by the first two phases of development of Swiss Federal Railways projects at the Pont-Rouge station, now under construction, the advertised space in the Quartet project in the Les Charmilles neighborhood, and the Swiss Federal Railways development at the Eaux-Vives station (O’Vives). In the outer business districts, however, the volume of advertised office space has increased slightly (+10’000 m²), especially near the airport, between the city limits and the national border along the Route de Meyrin. These comprise both existing and new buildings, such as the Atrium Park in the former industrial park ZIMEYSA between Meyrin and Satigny.

The stock of available office space in Geneva has been hovering around the high level of 300’000 m² (cf. fig. 13). since the beginning of 2016. Although this is lower than the record set in 2015, Geneva’s supply rate of 7.5% in the third quarter of 2017 is still the highest of all the office markets in Switzerland. In contrast to the Zurich market, however, the increase in the supply rate has been halted. The supply situation in Geneva is likely to remain challenging for some time to come, given the various development projects spurred by high demand for modern offices, and many firms’ desire to consolidate operations at as few locations as possible.

Restructuring in the banking and commodities sectors, which have a considerable impact on Geneva’s economy as they account for more than 14% of jobs, has a chilling effect on the local labor market and depresses demand for office space. Nonetheless, other growth sectors, such as...
corporate and public services, had a mildly positive net effect with additional demand of some 5000 m², or around 0.1% of the office stock. A moderate increase in demand to around 16'000 m² (0.35% of inventory) is expected in 2018. Geneva’s economy remains lively, as is evident in the smoothed annual 3.9% increase in the number of cross-border workers in the third quarter of 2017. While the commodities sector enjoys a brighter outlook now than in previous years, structural change in the banking sector will likely continue to weigh on future demand.

**Price correction halted – for now**

Data from Wüest Partner indicate that after three years of correction, market rents in the city of Geneva stabilized in the second quarter of 2017 compared to the previous year. Rents have been moving sideways over the last year, declining a total of 9.8% from the high in 2013. According to Fahrlander Partner, the price correction to date amounts to 14.9%. The price trend is not the only market indicator pointing to brightening conditions. The official decline in vacant office space in the canton of Geneva underpins the tendency towards stabilization. Reported vacant office space declined by nearly 13% to 158'000 m² between 2016 and 2017. Lower vacancies in Carouge, Vernier and Versoix were contrasted by higher vacancies in Lancy and Meyrin, while only meager progress was made in the city of Geneva. As a result, the current level of vacancies is still nearly double the 15-year average for Geneva. Furthermore, the average amount of time an object stands empty has risen from 13.2 to 15.6 months. As long as the oversupply of office space remains, demand stays moderate and new offices nonetheless continue to be built, there is little chance of a recovery in rent prices in the most expensive office market in Switzerland.

**Investors count on flexibility**

Despite the challenging marketing situation, Geneva’s building planners are not idle. The 12-month total of building permits for office projects in Geneva stands at CHF 100 million, around 20% higher than its long-term average (cf. fig. 12). One prominent entry on the list is the building permit for Îlot B in the planned Quartier de l’Etang neighborhood in Vernier with total investments of CHF 90 million. When lease prices are under pressure and the supply remains dynamic, investors must rely on their innovative capacity. Two projects in Plan-les-Ouates illustrate this well. Espace Tourbillon and Stellar 32 both offer highly flexible space that can be adapted to various types of tenants. Conceived primarily for industry, the floors can also be furnished for creative office professions such as architecture or engineering, if the tenant wishes. Stepping away from a “monoculture” allows an investor to cover a broader demand spectrum and thus raises the chances of successful marketing. Moreover, this can result in an interesting mix of tenants that contributes to both the attractiveness of the location and the avoidance of vacancy risk. Two of the five Espace Tourbillon buildings have been sold by the investor Swiss Prime Site to a non-profit foundation.

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**Figure 12: Approved construction projects for office space**

12-month total and long-term average on the Geneva market, in CHF million

**Figure 13: Trend in advertised office space**

Advertised office space: quarterly totals (existing and new constructions) in m²

Source: Baublatt, Credit Suisse

Source: Meta-Sys AG, Credit Suisse

*space advertised on the internet*
Available space in Bern’s office market is concentrated in the Central Business District (CBD) as well as numerous locations in the outer business districts (cf. fig. 14). In the CBD, office space is available primarily around the train station and in the Monbijou neighborhood. The former is probably a temporary phenomenon due to new space that was successfully leased in the PostParc building, but created a short-term local oversupply. The latter seems to stem from the federal government’s strategy of consolidating administration units at a few locations. As for the locations in the outer business districts, vacancies persist in Bümpliz-Süd and at the former Swisscom premises (Officepark Bern) on the Ostermundigen border. Recently, there was also an increase in advertised office space around the Gümligen train station. In the south of Bern’s market, where new office space has tended to be relatively well absorbed lately, the move by Losinger Marazzi back into the city of Bern created vacancies in Köniz (Sägerstrasse 76/78), but assured an almost seamless lease of space in WankdorfCity. This example shows that the office construction of the last few years has had a tangible effect. The demand dynamic in Bern’s office market is simply too meager to prevent such effects. A similar case concerns the Webergut building in Zollikofen, which, after the removal of the Federal Court to Eastern Switzerland, has had ongoing problems finding new tenants.

Demand has stagnated in the current year, but the forecast increase in economic growth across Switzerland in 2018 should generate organic surplus demand of around 16'000 m² of office space. A significant portion of this growth in demand is likely to be concentrated in the outer business districts where certain locations, such as WankdorfCity, are positioning themselves as new focal points of office activity in the region. Growing cost pressure on former government-operated enterprises, whose headquarters and back-office departments are key players in local demand for office space, could jeopardize this positive development. The Swiss Federal Railways, as part of their RailFit 20/30 strategy, are planning to cut staff by a net 1000 persons by 2020. Around half of the cuts are aimed at office personnel and supervisors. PostFinance, the banking arm of the Swiss Post, published a comprehensive restructuring plan in September that includes a reduction in overcapacities of office space that is likely to involve more than 10'000 m². While the savings measures mentioned in the plan will be implemented across Switzerland, Bern, as the location with the highest number of jobs in the former government-operated enterprise, could suffer more sharply from the capacity reductions.

Over the last few quarters, weak stimulus from the demand side was mirrored by a quiet situation on the supply side without sizable additions of office space. This gives Bern’s office property market time to adjust to the surge in production in the recent past. At the end of the third quarter...
of 2017, advertised office space in the region of Bern had fallen to 117'000 m², which
corresponds to a decrease of 2% over the preceding 12 months (cf. fig. 16). As expected, this is
a continuation of the reduction in the supply of office space. However, this observation applies only
to the CBD and extended business districts. In these environs, the volume of advertised office
space was lowered by around 9000 m². In contrast, the situation in the outer business districts,
which account for a growing portion of the advertised office inventory, is more or less unchanged.
Now, nearly four fifths of the supply is concentrated in these areas. Considering all the available
office space, the total market has a supply rate of 3.4%. Thus Bern remains the major city with
the lowest supply rate in Switzerland.

Stable lease prices

The amount of vacant office space in the city of Bern was slightly lower at mid-2017 than it had
been a year earlier, but was still at the 2015 level. Since 2015, vacancies in the Swiss capital have
been hovering around 70'000 m². The bulk of this figure relates to a few large spaces that have
been without tenants for years. Consequently, net rent prices asked declined from CHF 218 per
m² of vacant office space to CHF 212. On balance, market rents for office space in the region
have barely moved since a mild correction at the end of 2012. In the third quarter of 2017, the
average rents offered in the extended business district, where supply is virtually non-existent, as
well as in the central areas of the CBD, were highest at around CHF 285 per m² and year.
Tenants in less expensive areas are generally able to find suitable objects in the outer business
district, where the average is around CHF 190 per m² and year.

More office space in the pipeline

With the exception of a new administration building for the Federal Department of the
Environment, Transport, Energy and Communications (DETEC) in Ittigen in November 2016 (CHF
150 million), no major building permits in Bern’s office market have been approved (cf. fig. 15).
Despite this underlying calm, production of office space in the Bern region remains dynamic. The
project for further development and enlargement of WankdorfCity is off and running. The second
building phase, featuring realization of Mobiliar’s TRIO project and the Swiss Federal Railways’
Byte project, will add around 30’000 m² to the available space in Bern’s office market by 2020.
The Cantonal Police of Bern, originally interested in moving into existing space, is now planning to
establish headquarters in the municipality of Köniz. Construction of the new building, to comprise
80’000 m² of space, is slated to begin as of 2022. With this project, 60% of the 18 existing
locations of the Cantonal Police of Bern can be consolidated. Bern’s office market will thus
continue to be affected by consolidations and mergers of business locations in the coming years. A
return to the remarkably low level of less than 100’000 m² of available space is thus virtually
impossible in the near future.
### Basel

**Office space is scarce in the CBD**

In the Central Business District (CBD) of Basel’s office market, the supply rate of 2.7% is lower than any other major city in Switzerland except Bern. The supply concentration is relatively low because just a few smaller existing offices are advertised (cf. fig. 17). Larger spaces can be found in the extended business district near the train station, where new buildings are already complete (Grosspeter Tower), under construction (Meret Oppenheim Hochhaus) or in planning (B City). These projects are largely responsible for the higher supply rate of 4.9% in the extended business district, where nearly 29'000 m² of office space was advertised in the third quarter of 2017. As in other major cities, new development projects seek locations near train stations. The chain of available office space extends eastward, via the long-planned CityGate Buildings A and B, the Polyfeld in Muttenz (Lagonda House, Qube, BusinessCity) and the completed towers around the Pratteln train station (Ceres Tower, Aquila Tower, Helvetia Tower). However, as the distance from Basel’s city center increases, so does the difficulty in marketing the space. While occupancy rates are good in offices near the Swiss Federal Railways Basel station, offices further afield have greater difficulty finding tenants. This may also be due to the fact that rent prices in Basel are quite attractive compared to other major centers. The resulting minor price difference is insufficient to tempt tenants out of the central locations. This is precisely why the advertised supply has recently shifted towards the outer business districts, which now make up nearly two thirds of all advertised space on Basel’s office market. Potential office tenants have numerous options, also in the northern areas of the urban canton. For example, nearly 5300 m² of flexible-use space is available in the Horburg Learning Center in the Klybeck quarter, and nearly 3200 m² in a repurposed industrial building at Uferstrasse 90.

**Local economic structure offers growth potential**

Basel’s office market depends heavily on the success of its most important business sectors: life sciences, insurance and the broad array of corporate services. One out of three workers in Basel is employed in one of these sectors. Thanks to the bright outlook for employment in these core sectors, additional demand in 2017 is likely to exceed 13'000 m², which corresponds to more than 0.35% of Basel’s office market. Demand should increase to around 22'500 m² in 2018, which amounts to 0.6% of the supply. Basel’s office market should thus display the most dynamic demand for office space among the major Swiss centers. However, providers of office space cannot use this future growth to project their rental income. As a rule, the big players in the sector use their own initiative to address their increasing need for office space; like the multinational pharmaceutical firms with their industrial sites, Bâloise and Helvetia have also taken matters into their own hands and are building their own headquarters. Note also that new concepts in workspace tend to reduce the overall need for office space. This is why Syngenta decided against a new addition to its headquarters, because even after demolition of the Geigy high-rise, it still had adequate capacity.
The pattern in vacant office space confirms the trend toward a shift in available space to the outer business districts. The nearly 60,000 m² of vacant office space in canton Basel-Stadt is not far off the long-term average. In canton Basel-Landschaft, on the other hand, vacancies have risen to 85,000 m², nearly double the long-term average. The same pattern is visible in the supply rate. Mainly due to additional supply in the outer business districts, the available space in Basel’s office market has risen to over 140,000 m², which corresponds to an overall supply rate of 4.4% (cf. fig. 19). Although not all office space in Basel is listed online, the amount advertised is small compared to, say, Zurich. So it would be inaccurate to say there is an oversupply in the Basel market. Market rents have not yet reacted to the renewed rise in the supply rate, and according to data from Wüest Partner, they have been in a stable trend since mid-2015 with an annual increase of 0.8%. In the third quarter of 2017, the average annual rents offered were highest in the CBD at CHF 268 per m². In the outer business districts, rents for available office space were significantly lower at CHF 182 per m².

With preparations now under way for construction of Roche Building 2, history is repeating itself on Basel’s office market. Construction of Building 1 had already raised fears that the 74,000 m² of space would disrupt Basel’s office market. After all, Roche is building not only on the Wettsteinareal, but also in Kaiseraugst, which among other things is slated to house its entire IT operations. The vacancies in the building on Aeschenvorstadt 56, where Roche previously had its IT Learning Center, prove that the multinational pharmaceutical firms’ construction activity is not leaving Basel’s office market unscathed. Once Roche Building 2 is complete as of 2022, the company could begin vacating premises in other locations in Basel-Stadt. In the case of Building 1, these fears were unfounded. This time too, much will depend upon Roche’s growth over the next few years and its global location optimization strategy. As shown in figure 18, the construction of Building 1 coincided with a period of relatively little construction investment in Basel. The current situation is not nearly as comfortable. On the edges of the office space market, projects such as BaseLink and Project 47 in Allschwil, uptownBasel in Arlesheim and the further development of the properties Polyfeld and Hagnau in Muttenz will maintain the pressure from the supply side. Given the expansions by big insurance companies, this pressure is likely to become more intense in the central and extended business districts too.
Lausanne

Figure 20: Supply concentration of office space
Office space (existing and new buildings) listed on the internet for lease in m² per hectare, as of Q3 2017

In Lausanne’s office market, there is little space available in the Central Business District (CBD) or the extended business district, which reaches beyond Malley (cf. fig. 20). If at all in the CBD, then mainly smaller and mid-sized spaces in existing buildings, as was the case around the train station in the third quarter of 2017. However, these spaces have already disappeared from online portals and seem to be leased. Less than 25% of the entire supply of office space is found in the two inner business districts, and a mere 14% in the CBD. In contrast, there is a relatively large selection of advertised space in the outer business districts, where three quarters of available space is located. The supply is most dynamic in the West of the Lausanne region. Larger spaces are advertised in Renens, Crissier, Bussigny-près-Lausanne and Morges, some in existing buildings and some in planned developments. For example, 10'000 m² of the advertised space is found in the Swiss Federal Railways project at the Morges train station in the Quartier des Halles neighborhood.

On balance, the supply of office space in the second-largest market of Western Switzerland has declined compared to a year earlier (cf. fig. 22). In the third quarter of 2017, total available office space fell by 21% compared to the same period in 2016, which corresponds to a reduction of 35'000 m². With a supply rate of 5.2%, Lausanne is thus in the midfield of Switzerland's five major centers. The volume of advertised office space fell compared to a year earlier in the CBD (–20%) and especially in the extended business district (–60%). While consequently there is little office space available in the extended business district, the supply in the outer business districts has been around 100'000 m² for four years or so.

The diverse economic structure in the Lausanne region has supported demand for office space over recent quarters. Lausanne’s office market benefits from the fact that fast-growing businesses such as healthcare, public services and corporate services are well represented in Lausanne’s economic structure, and employ more than 50% of workers in the area. In 2018, organic growth in demand in Lausanne’s office market should rise to around 0.5% of inventory, or more than 15'000 m², thanks to the forecast acceleration in the economic recovery. On a longer-term horizon, Lausanne should further profit from a reduction in the ordinary earnings tax rate, approved by voters in March 2016, from today’s 21.7% to 13.8%. With its clear commitment to this rate, which is scheduled to be applied at the beginning of 2019, the canton of Vaud, in contrast to many other cantons, is creating fiscal security – a key factor for companies.

Despite the gradual reduction in the supply overhang, marketing remains challenging in Lausanne’s office market. Market rents in the city of Lausanne have been in a steady southerly trend since mid-2014. In the second quarter of 2017, prices took another plunge of around 4%
compared to a year earlier. We expect the market to stabilize soon, since Lausanne tends to slightly lag developments on other markets. This is particularly the case in the city itself, where officially registered vacancies are already falling. In contrast, vacancies in the East Lausanne district shot up to 31'000 m², the second-highest figure in the last 12 years. Vacant office space in the Western suburbs of Lausanne, such as Ecublens, Bussigny-près-Lausanne, Crissier and Renens, have contributed to the 17% rise in vacancies for the entire region compared to 2016. Longer advertising periods in the outer business districts likewise indicate a more difficult marketing situation at Lausanne’s periphery than in the city center. The market fundamentals are somewhat more positive in the region around Morges. Here the amount of vacant office space fell by 6800 m² from 2016 to 2017.

There are numerous projects in the pipeline in the Lausanne region. The 12-month total of building permits for office projects amounted to CHF 131 million in September 2017, well above the long-term average of CHF 85 million (cf. fig. 21). The cantonal buildings insurer, ECA, recently received a permit to construct its new headquarters in the extended business district of Lausanne. The new building, with a cost of CHF 80 million, is slated to open in 2020 with 22'000 m² of office space for some 300 employees. Also in the capital city of Vaud, the participatory process for the La Rasude project is advancing, so that construction work is expected to begin in 2020. Conceived by the Swiss Federal Railways’ real estate arm and Mobimo, the area aims to redefine the surroundings of the Lausanne train station, offering space for 3000 jobs, largely in the office sector, as of 2022. Last February, a permit application for a building complex in Lonay was submitted, with an investment sum of CHF 33 million. Part of the development is planned for office use. In November 2016, the objections blocking the continuation of the Quai Ouest project at the Renens train station were overruled by the Swiss Supreme Court. Construction of the first commercial building is planned for 2018, and the second for 2020. Altogether, the complete realization of the project will expand the supply of offices in the outer business districts by 6800 m². The Oassis project in Crissier will add another 7'000 m² of office space by the end of 2018. There is also great activity around the Morges train station. In the immediate vicinity of the Quartier des Halle project, which is already under construction, the realization of the Îlot Sud project is being planned. Provided the building permit process goes without a hitch, 3600 m² of office space will be built on the site by 2020. This pipeline full of modern and, for the most part, readily accessible office space will heighten the competitive pressure on older inventory objects around Lausanne by the end of the decade. Especially in the outer business districts, where the supply is already at a high level today and most of the new projects are planned, pressure is likely to increase. For the moment, however, further easing is on the cards.

Well filled pipeline, but little expansion before 2020

Figure 21: Approved construction projects for office space
12-month total and long-term average on the Lausanne market, in CHF million

Source: Baublatt, Credit Suisse

Figure 22: Trend in advertised office space
Advertised office space: quarterly totals (existing and new constructions) in m²

Source: Meta-Sys AG, Credit Suisse
Office markets in mid-sized centers

New horizons

As in many other countries, the real estate sector in Switzerland tends to focus on just a few major office markets. In the USA, the so-called "gateway cities" with a large supply of office space and readily available market information are natural investment targets. Given the marketing difficulties and pressure on net yields in major Swiss centers, now smaller, less prominent markets with higher risk premiums are also attracting investor interest. The rise of near-shoring strategies within national borders, in which certain corporate operations are transferred from expensive cities to lower-cost regional centers, represents another argument for a closer consideration of regional cities. In the USA, smaller technology hubs such as Denver, Colorado and Portland, Oregon, as well as growing back-office locations such as the greater Raleigh-Durham area, North Carolina, have positioned themselves over recent years as the new El Dorado of office real estate investment. Against this backdrop, this study adds an overview of the 16 largest regional centers and to the detailed analysis of Switzerland’s five major centers above.

Neglected markets

When it comes to the size of the office market, Switzerland’s major centers deserve the name. Total office space in the markets of Zurich, Geneva, Bern, Basel and Lausanne amounts to nearly 24 million m², which is more than double the total of Switzerland’s 16 largest regional centers combined (10.5 million m²). The largest secondary market, Lucerne, has 1.5 million m² of office space, which is 40% less than Lausanne, the smallest of the big markets (cf. fig. 23). Only the top four regional centers report a figure over 1 million m² of office space; all the others fall short of this threshold. In many of the observed secondary markets, the supply rate amounts to 3% of inventory or less, which indicates a reasonable volume of available office space. Liquidity in Olten, Sion, Chur and Neuchâtel is rather meager with a supply rate of less than 2%. In contrast, the supply in the markets of Zug (4.5%), Schaffhausen (4.5%) and Lucerne (4.1%) can be considered quite dynamic. In the case of the two central Swiss markets, this is due to relatively high development activity in recent years, and in Schaffhausen to a short-term overshoot in the supply.

Easily accessible market information and sufficient liquidity are important criteria to make a real estate market attractive for professional investors. Against this backdrop, the office markets of the mid-sized centers are of less interest to real estate investors compared to those of the major centers, given their smaller size and limited transparency. According to the Real Estate Investment Data Association (REIDA), just 14.3% of net rental income was generated by office properties in...
mid-sized centers in the third quarter of 2017 (cf. fig. 24). This value has risen only marginally since 2013 (13.2%) and indicates potential for growth. Office buildings in major centers, on the other hand, are disproportionately represented in institutional investor portfolios with a relative market size of 77.8%.

**Structures vary among the mid-sized centers**

Some mid-sized centers are in no way inferior to major centers when it comes to the accessibility of human capital. Baden, with nearly 780'000 workers in its catchment area, has the country’s second-best accessibility for employees after Zurich (cf. fig. 25). In addition to large regional centers such as Winterthur, Lucerne or Biel, smaller cities in the Mittelland with excellent transport connections, such as Aarau, Olten or Solothurn, are also very well positioned in this respect. In contrast, suburbs in alpine regions are at a disadvantage due to their distance from the large metropolitan areas and their difficult topography. The catchment areas of Sion and Chur, which are at the bottom of these rankings, contain just 180'000 and 280'000 potential employees, respectively.

While many mid-sized centers have significant worker potential in quantitative terms, they can hardly compete with the five major Swiss centers in terms of worker qualifications. One exception from the rule is the economic region around Zug, where more than 46% of the working-age population have benefited from tertiary education (cf. fig. 25). The populations of Baden and Winterthur, which are closely linked to metropolitan Zurich, also boast rates of 39.5% and 41% highly qualified workers, respectively – an education profile that diverges only slightly from that of the major centers. The university cities Fribourg, Neuchâtel, Lucerne, Lugano and St. Gallen all range around the Swiss average of 35%. The lowest percentages of highly qualified workers are found in Thun (28%) and Olten (28%). Here, the economic structures are characterized by less knowledge-intensive sectors, such as construction in Thun and transport in Olten.

A limited market size need not exclude attractive development perspectives. According to our in-house opportunity-risk approach, which evaluates the sector mix of each location in terms of the growth potential for each established sector, the economic structures of all analyzed mid-sized centers display above-average development potential (cf. fig. 26). Behind the two major centers of Basel and Lausanne, Fribourg surprisingly takes third place. However, the importance of this third place for the office market must be put into perspective: the growth potential of Fribourg’s economy gets a particular boost from a high percentage of workers in the education/training and healthcare sectors, where we identify good growth prospects. This is largely due to the 2500 employees at the University and the cantonal hospital. Neither of these important institutions, by the way, can be considered a typical office tenant, although their need for office space should not be underestimated. Winterthur and Zug are also in the top rankings. Like Fribourg, Winterthur...
benefits from the prominent role of education and training as well as healthcare and nursing in its sector mix. Positive contributions are also made by the engineering, architecture and IT businesses. In Zug, growth potential – aside from the substantial commodity trading sector, which has a neutral outlook – stems mainly from the growing sector of corporate services and the high-tech industry. Interesting sector portfolios can be found hidden in the mid-range of the rankings too. The economic structure of Schaffhausen, for example, is enlivened by a significant pharmacy cluster. The university and hospital seat of Neuchâtel, another city influenced greatly by education and healthcare, gets a boost from the microtechnology industry. Lucerne and St. Gallen in turn act as regional centers with broadly diversified economic structures and high availability of key central services.

The lower section of the table shows that the lower growth prospects in Baden’s economic region are largely due to the strong presence of manufacturers of electrical equipment, especially since this sector currently has below-average development potential. Lugano is affected, among other things, by the significance of the banking business, which is undergoing structural change. According to the applied valuation methodology, Sion and Thun, where the construction industry is predominant, and the industrial cluster in Biel have economic development potential that is only slightly higher than the Swiss average. This group includes the Olten region, whose sector structure is heavily oriented towards ground transport.

Great stability in the mid-sized centers

In times when cost optimization plays an increasingly important role in corporate strategy, potential savings in office leases become more attractive. Besides reducing office space per employee with innovative office concepts such as Smart Working, another option is to move certain departments away from expensive central markets into more economical locations. The low price of office space in some mid-sized centers is a strong argument in favor of such strategies. A comparison of area-weighted rents offered reveals that rent prices in nearly all of the 16 observed mid-sized cities are lower than those in the big cities (cf. fig. 27). Only in the case of Basel does this apply to only about half the mid-sized centers. These markets offer office space at an average annual net rent of just CHF 200 per m² or less. Average rents are significantly higher in secondary markets such as Lugano or Zug, where economic momentum is similar to that in the big cities. In the past, the cost argument has driven a trend of back office operations being moved out of city centers to the readily accessible perimeters of the office space markets. Now, mid-sized centers are also being considered for such moves – and not only because of lower prices. In addition to the cost argument, mid-sized centers also offer a pool of workers for large companies’ back office operations as well as a less fiercely competitive labor market.

Less impetus for expansion, lower vacancies

Being overlooked as a target market for office property investment has had some benefits for mid-sized centers. In most secondary cities, the limited capital inflows from major investors is positive for the stability of the office market. While volatility in planning activity for offices in the major centers has amounted to nearly 33% over the last 12 years, the figure was only 23.5% in the mid-sized centers, which suggests fewer surges in office production. The largely moderate supply rate in many office markets in the mid-sized centers (cf. fig. 23) corresponds with less erratic planning activity. The more stable supply in secondary markets is also reflected in a comparison of vacancies in the portfolios of big institutional investors. From 2013 to the third quarter of 2017, the share of unrealized net rental income in the mid-sized centers was lower than in the major centers and the rest of Switzerland (cf. fig. 28). In particular, the stable trend in vacancies in the mid-sized centers under review does not match the sharp deterioration in marketing office properties between 2013 and 2016 at national level.

Mid-sized centers: element of a diversification strategy

The office markets in mid-sized centers also have a different profile than those in the major centers and bring new qualities to the table. Their smaller size and the lower availability of properties make them unlikely candidates to become the new investment El Dorados for office space, especially in the prime segment, analog to secondary cities in the USA. Nonetheless, they offer diversification potential through the variety of their economic structures and lower competition, which argues for a higher weighting of these markets in the office property portfolios of professional investors. Their current share of 14.3% offers considerable upside potential. Besides a better geographical distribution of risks, an increase in their portfolio share would have a stabilizing effect, especially
since they represent partial protection against income fluctuation from the more cyclical markets of the major centers.

The 16 markets of mid-sized centers under analysis can be grouped into two main categories in terms of investment strategy. The first group would be appropriate for investors aiming to participate in the organic growth of the local economy and the resulting additional demand for office space. A good macroeconomic outlook for the location, as well as a healthy basis for the office property market, especially a low supply rate, play a key role in this approach. Markets such as Winterthur, St. Gallen, Fribourg or Neuchâtel would be especially appropriate for such a strategy. Another point of view is to bet on the savings potential available to companies that move from major centers to cheaper premises in mid-sized centers. In this case, the quality of the local economic structure is of less significance. The rent levels for office space and the number of accessible workers are the key factors here. The population’s education level is less critical, since near-shoring strategies tend to affect less knowledge-intensive jobs. The selected location should be outside the commuting distance to a major center in order to tap new labor reserves. Many cities in the Mittelland such as Olten, Solothurn and Biel are good candidates for this approach.

**Figure 27: Rent levels in the individual office property markets**

Area-weighted net rents offered for office property in CHF per m² and year, as of Q3 2017

![Graph showing rent levels in various cities with different strategies for different market profiles.](source)

**Figure 28: Vacancy rates in institutional investors’ office property portfolios**

Unrealized net rent income as % of theoretical total rent income by region. Data for Q3 2017

![Graph showing vacancy rates in various cities with different strategies for different market profiles.](source)
Outlook for the office property market in 2018

Our analysis indicates that the growth rate of the Swiss economy will accelerate to 1.7% in 2018. An improving earnings situation should encourage companies to increase their investment activity, which would stimulate job creation. However, cost optimization is set to remain a dominant theme in corporate strategy. This exerts pressure on the amount of office space per employee, which in turn would weigh on demand momentum. Since the phase of negative interest rates is likely to extend into 2019, office property investments will remain an attractive option given the lack of interesting alternatives. Against this backdrop, no significant deceleration in project planning is anticipated in 2018. Despite a gradual convalescence in the office property market, the situation remains fragile and vulnerable to shocks. Marketing office space will likely remain a challenge in many regions, particularly in the case of older and less accessible inventory objects.

**Demand**

Starting point: ➔  Outlook: ↘

The gradual acceleration of the Swiss economy and the resulting improvement in the labor market situation should have a positive effect on demand for office space, even if the tempo is slower than it has been in previous cycles. We expect additional demand of 300’000 m² in 2018. As in the past, the healthcare sector and public services should make a significant contribution to this positive momentum. Stimulus is also generated in the corporate services sector and certain segments of manufacturing. Demand in the manufacturing sector benefits not only from the depreciation of the Swiss franc, but also from a continuous tertiarization process that steadily increases the need for office workplaces.

**Supply**

Starting point: ➔  Outlook: ↘

The modest planning activity from 2013 to 2015 is likely to be reflected in a merely moderate expansion of office space in 2017 and 2018. We therefore anticipate a slight and temporary decline in the supply rate in the coming quarters. Longer term, however, the recent increase in planning activity will jeopardize a continuation of the recovery. Most of the office space advertised for rent will likely be concentrated in the major centers, particularly on their perimeters, keeping the supply rate at a high level, especially in Zurich and Geneva.

**Vacancies**

Starting point: ➔  Outlook: ↘

For the first time in five years, reported vacancies, which as a sample make up 43% of the office property market, declined slightly in 2017. Nonetheless, with a total of 630'000 m² of empty offices, the figure is still at a very high level in historical comparison. Given the expected increase in additional demand and the temporary dip in supply, we forecast a further mild reduction in reported vacancies in 2018. This is largely due to the fact that vacancy surveys are concentrated in core cities.

**Rent prices**

Starting point: ➔  Outlook: ➔

The slow reduction in the oversupply, a result of stabilizing demand momentum as well as a temporary dip in new office space coming onto the market, led to stabilization in rent prices in most local markets. The fact that supply is still very high, combined with an only gradual recovery in demand and an acceleration in project planning activity, argues against a new upward cycle in office rents for the time being. We therefore expect market rents to move sideways on balance.

**Performance (total return)**

Starting point: ➔  Outlook: ➔

The sizable capital flows into office properties in recent years have pushed net yields down to a very low level. Except in exclusive premium locations, we believe that the upside potential is exhausted. The forecast stagnation in rent prices and the persistently difficult marketing situation hold little promise of rising rental income. Against this backdrop, we expect office property investments to deliver an unspectacular performance in 2018. Total yield depends increasingly upon the net cash flow yield, but is still considerably more attractive than alternative investments.
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