Sophisticated financing in 2024 - the new reality

By Dr Roger Stettler & Thomas Hilpert, 03.09.2024

The first half of 2024 was marked by declining short- and long-term interest rates, along with a continued reduction in financing availability in certain market segments, especially for conversions and construction projects. Optimizing cash flows and leveraging alternative financiers who can bridge the gaps left by market pullbacks remain crucial.

Falling interest rates

Similar to the unexpected and rapid increase in interest rates in early to mid-2022, long-term capital market interest rates responded much more swiftly than short-term SARON rates, which are heavily influenced by the SNB.

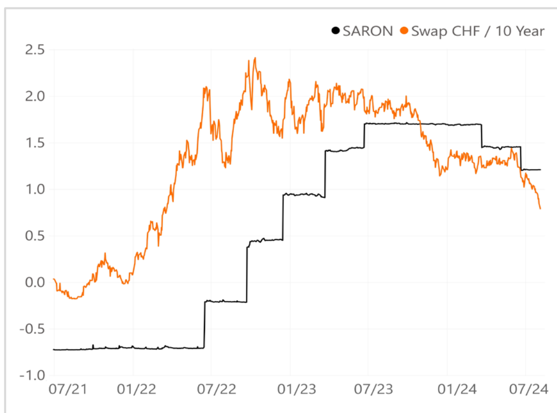

Figure 1: Interest rate development SARON and SWAP rate

The 10-year CHF swap fell from over 2.00% in summer 2023 to below 0.80% at the beginning of August 2024. The SNB then lowered the SARON target rates with a delay in March 2024 and June 2024 to 1.25%.

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This development has undoubtedly greatly improved the cash flow situation for most property lien investors, especially compared to the challenging year of 2023.

Rising target rents

Market rents continued to develop positively over the course of 2023 and the beginning of 2024.

The gap between actual and target rents has narrowed significantly for old contracts due to the increases in the reference interest rate .

However, aligning rents for new leases with market prices consistently remains a challenge. The incentives of many property managers often differ from those of property owners. Many property managers

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prioritize re-letting properties quickly, sometimes bypassing time-consuming advertising or viewings, e.g. such as by finding a new tenant from the existing neighborhood. However, this approach often falls short of effectively achieving market rent levels.[1]

It would be beneficial for the sector to consider new compensation models for property management companies. For example, these models could include bonuses for property managers when they achieve or exceed target rents for new leases, helping to align their interests with those of property owners.

Without these models, property owners' asset management teams must be actively involved in every new lease agreement.

Problem area construction projects

Since 2023, it has become evident that even seasoned, reliable construction developers have faced significant challenges with project financing and often need to turn to bridge and mezzanine financing.[2]

This trend is ongoing, and many banks are struggling to adjust their credit regulations to accommodate these types of customers. This difficulty persists despite the fact that the objective economic risk of such projects has been significantly mitigated by the low construction inflation, which has been below 1% from April 2023 to April 2024.[3]

We anticipate that in the future, more risk-sharing models will emerge, where investors will receive a substantial share of a project's profits instead of traditional interest payments.

One obstacle is the property profit tax, which can result in a significant tax burden in cantons with a monistic model (such as the "Zurich model") when the holding period is short—a scenario that is particularly common in construction projects.

Market withdrawal 1: UBS / Credit Suisse

The impact of the takeover of Credit Suisse by UBS is being discussed intensively on the market.

> "The gap left by Credit Suisse is noticed in the market and is filling very slowly."

Economically, the loss of an important provider leads to a lower supply and rising prices (oligopoly). Credit Suisse played a very important role in many submarkets and was known for its creative and flexible solutions. Accordingly, certain client segments are particularly affected by the loss of Credit Suisse.

Other providers have partially filled these gaps, but the loss of Credit Suisse remains significant, particularly for very large

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[1] See article: "Inflation and rent adjustments for residential property"

[2] See article "Bridges Loans"

[3] Source: Construction price index, FSO

financings, M&A transactions, and certain retail segments.

Market withdrawal 2: Pension funds

In response to the low and negative interest rate environment, pension funds significantly increased their involvement in the Swiss mortgage market. Mortgages were viewed as an alternative to investments in CHF bonds, with pension funds focusing primarily on longer maturities. This shift was facilitated by intermediaries and occurred both directly and through indirect vehicles, such as investment foundations. The peak of this trend was reached in 2021.

Pension funds have traditionally focused on "standard cases," such as financing owner-occupied residential properties and apartment buildings with low loan-to-value ratios.

As interest rates rose, the attractiveness of mortgages compared to bonds decreased significantly. At the same time, pension funds experienced substantial cash value losses, which were also reflected in the risk ratios of indirect investment vehicles.

Since the beginning of 2023, these providers have reduced their new volume to nearly zero, and most portfolios are being gradually wound down.

While this withdrawal has not been very dramatic for the market overall, some intermediaries may be affected. Pension funds were primarily active as price leaders in market segments with intense competitive pressure.

As a new development, we observe that some pension funds are investing smaller amounts in higher-risk credit tranches with shorter maturities, focusing on credit risk rather than duration risk.

Higher gross yields at constant prices

At the start of the interest rate hike, there were concerns that it would lead to significant price corrections in the Swiss property market. These fears were intensified by substantial corrections observed in markets such as Germany and the USA.

The fact that residential property prices in these markets experienced much more dynamic growth from 2020 to 2022 than in Switzerland was overlooked. As a result, the "drop" in property prices in Switzerland was less pronounced.

In practice, residential property prices have remained relatively stable over the past two years. A closer analysis reveals that the increase in capitalization rates has been balanced by rising rents. This was feasible because the favorable economic conditions in Switzerland supported rent increases, unlike in some foreign markets.

Old problems - new products

The processing times for loan applications and the time between enquiry and actual disbursement have increased further over the last 12 months.

For loan amounts starting at CHF 3 million, processing times often exceed 2 months, even with complete documentation and a strong credit rating.

This stands in contrast to an active property market where speed is crucial for successful transactions.

"Processing times for loan applications are getting longer, with 2 months from inquiry to disbursement becoming the norm."

Due to their stable and predictable business operations, property companies typically maintain low levels of liquidity.

We are increasingly seeing bridge financing being used for purchase transactions, even though traditional mortgages from banks would have been feasible in terms of risk and loan-to-value ratio.

Outlook

The market anticipates further interest rate cuts in the coming months, especially at the short end. This is expected to improve the cash flow situation for property companies and stimulate demand for residential property.

At the same time, there are few signs that the specific issues, such as increasing processing times for loan applications, the gap left by Credit Suisse's demise, and the exit of certain pension funds, will be resolved.

This situation will further elevate the role of alternative financiers in bridging these gaps.

Hyrock is an independent mortgage and real estate expert for sophisticated private and institutional clients in Switzerland at its locations in Zurich, Schindellegi and Geneva. In 2023, Hyrock implemented financing solutions for its clients totaling CHF 918 million with an average loan size of CHF 5.4 million per transaction. Thereof, CHF 349 million were mezzanine and bridge loans. www.hyrock.ch