

## ITALY REAL ESTATE STRATEGIC OUTLOOK

Mid-Year 2021

### IN A NUTSHELL

- \_ We see a window of opportunity in the logistics sector as demand for space is growing and yields are high relative to other European markets.
- \_ Residential is becoming an increasingly important sector for investment. We expect a focus on forward funding in commuter locations to yield strong performance.
- \_ The office sector remains uncertain as occupiers hold back on expansion plans, while the outlook for retail looks particularly challenging despite still-low rates of online sales in Italy.

The pandemic has resulted in a shift in our strategy in Italy. Office has become less of a focus, as weak demand – except for the very best-quality assets – is likely to result in slow rental growth, and pricing is tight. While investable stock in the residential sector is currently low, we see opportunity in forward funding development in Milan where the fundamentals are most attractive. Our outlook for logistics remains positive as we still see room for yield compression and the sector is at an early stage of development in Italy.

### Economic conditions improving but outlook uncertain for offices

After a strong contraction in 2020 and early 2021, Italy's economy is now on a path towards renewed growth. With almost half the population vaccinated, mobility is increasing and economic sentiment is at a 20-year high.<sup>1</sup> We expect Italian GDP growth to outperform the Eurozone in 2021 and 2022, bringing output back to pre-pandemic levels by the end of next year.

There is a clear downside risk to the current Covid-19 situation in Europe, with the Delta variant yet to be brought under control. This may slow the recovery in employment prospects, particularly in Rome where the tourism industry is more dominant. While hiring intentions and monthly employment numbers were up month-on-month in July,<sup>2</sup> the growth was mostly in temporary employment, which could be reversed if restrictions are re-imposed. In the long term, an aging population is likely to dampen growth and overall we expect the Italian economy to lag that of the Eurozone.

However, in Milan, expected GDP growth of over 5% per annum over the next two years puts the city some way ahead of the national average. Even so, the office market in Milan is not a key focus at present. Net absorption in 2020 was negative and we expect this to continue into 2021 as occupiers choose to upgrade their office space rather than expand.

<sup>1</sup> Eurostat, July 2021

<sup>2</sup> Oxford Economics, July 2021

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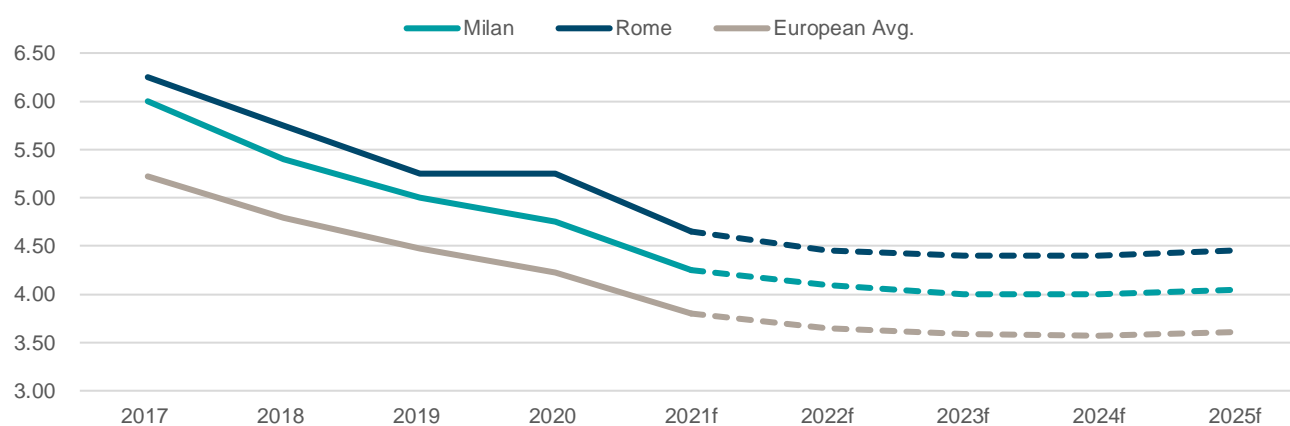
Supply growth is expected to be limited over the next five years but as demand is likely to remain tepid considering changes to home-working trends, we see vacancy continuing to grow. As a result, we expect rental growth to underperform the European average.

## Main investment opportunity in logistics

Milan is one of our top-performing logistics markets over the next 10 years. Yields are still high compared to most other European markets but the gap is closing quickly. And despite a weak outlook for the Italian economy in general, Milan is a promising e-commerce market, with higher income growth and a wealthier population than other metropolitan areas in Italy. The logistics infrastructure is still developing, and much of the existing supply is dated, leaving room for new development.

Rome has fewer positive fundamentals, but we still expect outperformance in this market. While the population is less wealthy than Milan, there are approximately one million more inhabitants in Rome and the current logistics infrastructure is inadequate to serve growing e-commerce needs.

### LOGISTICS PRIME YIELD OUTLOOK (%)



Source: DWS, July 2021. F = forecast. There is no guarantee the forecasts shown will materialise. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Forecasts are not reliable indicators of future returns.

## Residential on the increase

The private rented sector in Italy is at an early stage of development, but investment volumes this year suggest the market is starting to attract investor interest. Private renters are very much in the minority in Italy, but the proportion is on the rise, having grown from 13% to 19% of the total over the past ten years.<sup>3</sup>

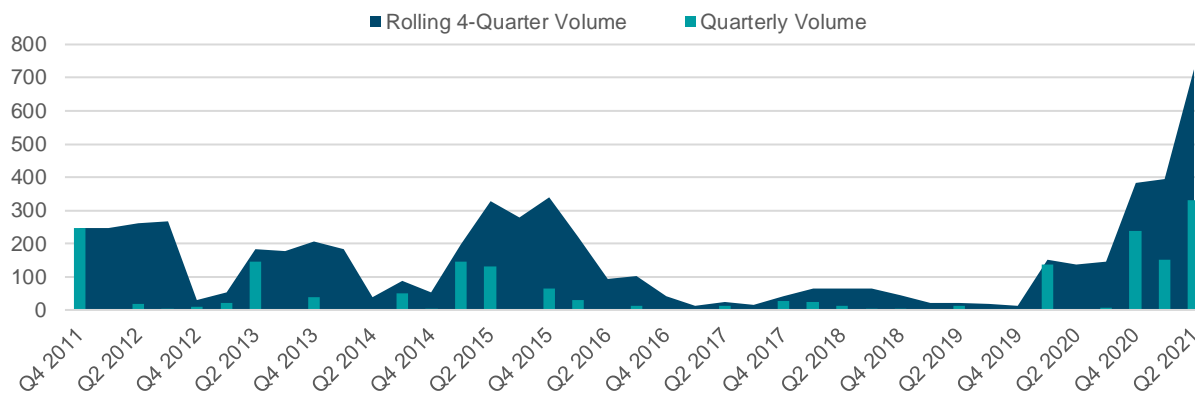
Milan is the main area of opportunity. It is one of the only cities with projected population growth in Italy and has a high proportion of renters (almost 30%).<sup>4</sup> Having seen annual average rental growth of 2% over the past ten years, the prospects for further growth are good, supported by rising household incomes. As there is very limited existing stock of build-to-rent accommodation, and supply growth has lagged demand, we see opportunity for investors to develop stock to meet expanding demand. This strategy also allows a potential higher return on investment as prime net initial yields in Milan are now around 3.00%.<sup>5</sup> We prefer locations in low density, predominantly residential areas outside the city centre such as Bicocca, which combine affordability with accessibility for residents.

<sup>3</sup> Eurostat, August 2021

<sup>4</sup> ISTAT, January 2021

<sup>5</sup> JLL, June 2021

## ITALY RESIDENTIAL SALES VOLUME (€M)



Source: Real Capital Analytics, July 2021

## Select opportunity in hotels

Investor sentiment towards hotels has been weak over the past year due to the sharp drop in all forms of travel. And with continued uncertainty over the speed of recovery in international travel, competition for well-located hotels in key tourist hubs in Italy has waned, leading to evidence of discounting. We feel that the long-term outlook for the tourist-led segment remains positive, and this is where the current pricing discount could provide opportunities. However, any acquisition should be made with increased levels of caution as many operators are more indebted than before the pandemic and may therefore be under increased financial stress. And with more downside risks around future demand for business travel, we see much greater risk around hotels which are dependent on conferences or trade fairs for custom.

Retail is another sector which has been significantly negatively affected by the pandemic. The lack of tourist and office worker footfall has resulted in a 12% decline in prime high street rents from Q2 2020 and vacancy has almost doubled from pre-pandemic levels.<sup>6</sup> Unlike hotels, we don't expect an immediate recovery. Our forecast is for further rental decline and by 2025 we expect shopping centre rents to remain 20% below pre-pandemic levels.

<sup>6</sup> RCA, July 2021

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