Real Estate Research

September 2022

Italy Real Estate Strategic Outlook

Third Quarter 2022

IN A NUTSHELL

- Political uncertainty and rising bond spreads have increased the levels of risk in Italy, although the impact on the real estate market has so far been minimal. Rising borrowing costs are expected to push prime yields up across all property types, with stronger rental growth set to partially offset the negative effects on capital values.
- All-property total returns are expected to underperform the European average due to a weaker economic outlook, although we see potential opportunities in certain sectors. Our focus is on the undersupplied affordable residential and student housing markets, both offer a yield premium over more established core European markets.
- We remain selective on logistics due to increasing speculative developments and a slowing economy, while larger price corrections in the office market could provide opportunites to refurbish older stock into Next Generation space.

Market outlook

Political uncertainty has returned to Italy, following the resignation of Prime Minister Mario Draghi. Italian government bond yields have risen and spreads over the German bund have widened to over 200 basis points based on lower confidence and an expectation of rising public debt. Furthermore, the impact of the war in Ukraine and global supply chain disruptions has been more severe in Italy due to the high dependence on Russian energy imports. Inflation hit a record 7.9% in July[1] and drought in the north put further pressure on food prices. Output recovered strongly following the Covid-19 pandemic, but growth is forecasted to slow sharply, with the economy only returning to its pre-GFC level in 2025.[2]

While the national economy faces numerous headwinds, certain cities and regions within Italy are predicted to outperform. The country as a whole faces the prospect of ongoing population decline, yet the demographic profile of cities such as Milan and Rome is more positive, with both forecast to see continued positive employment growth over the next decade, and Milan in particular seeing notably higher GDP growth.

With regard to the real estate market, we don’t yet see a major impact in Italy; however, the rising bond spread is expected to lead to investor caution. Sharp increases and volatility in the fixed income market have had a notable impact on borrowing costs and as a result, there is growing evidence of an ongoing price correction in the Italian real estate market. We anticipate outward yield movement across almost all sectors over the next 18 months.

[1] Istat, July 2022
[2] Oxford Economics, August 2022

Undersupply supports investment in student housing

With a price correction underway and occupier fundamentals potentially under threat, we believe that current investment strategy should focus on the most resilient sectors and markets. As such, we continue to see the attraction of affordable residential in Milan and student housing in cities with high-quality universities.

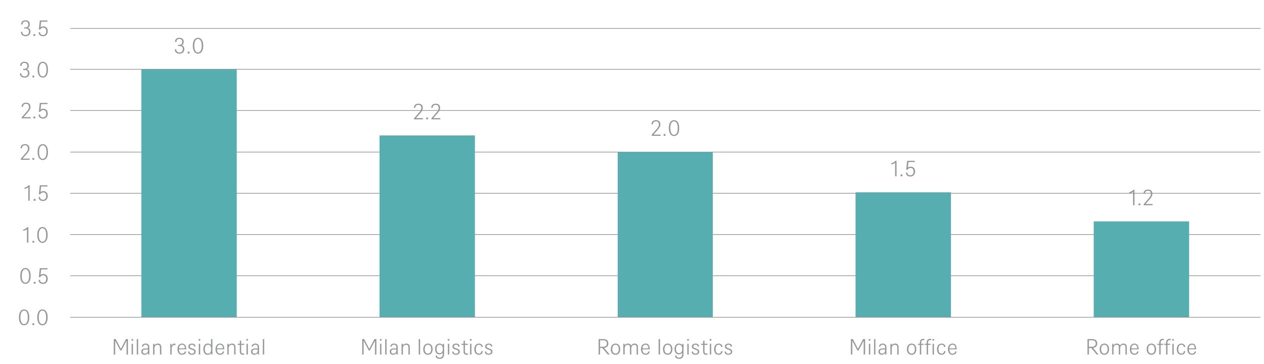
Residential has generally proven to offer reasonable protection against inflation over time, thanks to persistent undersupply, favourable demographic trends and typically shorter leases – providing opportunities for regular rental uplifts. The Italian institutional-quality residential market is also in a relatively early stage of development, offering attractive pricing relative to established European markets. While a weaker demographic profile could hamper the outlook for rental growth in some locations, our investment focus remains on Milan as the national outperformer.

Student housing is seen as an attractive alternative within the living sector, based on solid occupier fundamentals and a yield premium over multi-family residential. Total domestic student enrolment in Italy grew by 1.6% per annum between 2016 and 2020, despite a decline in the younger population (15-24-year-olds) over the same period. The current stock of purpose-built student accommodation (PBSA) relative to the full-time student population – also known as the provision rate – is among the lowest in Europe. While provision rates in Berlin and Paris are more than 10%, and London close to 30%, rates in Milan and Rome are just 6.5% and 3.0%, respectively, leaving significant room for the sector to grow[3]. Furthermore, student enrolment is typically inversely related to the economic cycle: The tougher the job market, the more likely the decision to study. Rental growth has therefore tended to perform well through downturns.

Logistics remains strong; offices to offer opportunities after repricing

Office occupier markets in Rome and Milan performed well over the first six months of 2022, as demand for high-quality space in the core submarkets led to prime rents maintaining an upward trend.[4] We expect fundamentals to remain robust and anticipate further rental growth, but the risks are clearly to the downside due to political and economic uncertainty. With older office stock accounting for a large proportion of availability, current high vacancy rates are unlikely to decrease, as occupiers increasingly demand high-quality, centrally located space with strong ESG credentials. Overall, we expect Milan to outperform Rome, but remain a laggard among the larger European markets, while expected price corrections due to increased borrowing costs and an economic slowdown could in time provide attractive opportunities.

Prime Rent Growth Forecast (2022-2031f, % p.a.)



Source: DWS, July 2022. Note: F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

[3] DWS, Savills and Bonard, 2021
[4] PMA, June 2022

The Italian logistics market has experienced increasing interest from international investors in recent years. Dynamic demand trends resulted in vacancy rates falling to less than 2.5%, despite increasing speculative completions[5]. Across Italy, a further 1.3 million square metres of new space is due to be completed by the end of this year, including a speculative component of nearly 70% of total completions. Looking ahead, rental growth for Milan logistics is forecast to be in line with the European average, with select submarkets and newer assets set to outperform. Assets located close to large urban populations are expected to see higher levels of rental growth, benefitting from greater supply constraints and strong demand from logistics occupiers looking to serve consumers directly.[6]

Another part of the logistics market that we think looks attractive is the cold storage sector, supported by solid demand and supply fundamentals. Recently, the storage of medical products has been a driving force behind temperature-controlled storage. We would expect the strongest demand for this type of product in Europe's largest manufacturers of pharmaceuticals, including Italy. Given the nature of the cold storage sector and the relatively high build costs, the segment is more insulated to the risks of over-supply that we see for regular dry storage in corridor markets. In addition, given often extensive tenant-borne investment in the fit-out of the building, cold storage tenants tend to be "stickier" and typically commit to longer leases at higher rental levels.

[5] CBRE, July 2022
[6] CBRE, July 2022

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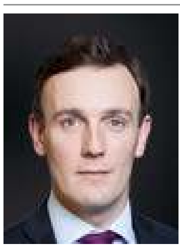

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Important information