Alternatives Research
Real Estate

February 2022

ITALY REAL ESTATE STRATEGIC OUTLOOK

First Quarter 2022

IN A NUTSHELL

_ Prime offices are still in demand, but secondary locations are losing appeal for both occupiers and investors. We recommend reducing exposure to secondary assets in weaker locations.

_ Italian logistics still offers a yield premium over other major markets, and total returns are expected to outperform the European average, but yields are compressing rapidly and the window of opportunity for investment is narrowing.

_ We see opportunity for investment within the residential sector, particularly in student housing, as more investable product is developed in what is an undersupplied market.

Promise of political stability boosting economic confidence

After a strong end to 2021, the Italian economy is likely to face some headwinds in early 2022 due to the spread of the new Omicron variant. In the medium term, the trajectory of the economy will be affected by the successful delivery of Prime Minister Draghi's reform agenda, combined with the deployment of the €235bn Resilience and Recovery Plan. While reforms to civil and penal justice, public administration, taxation, and land registry should be positive for the economy, many measures are politically sensitive and rely on follow-through by successive governments. For the time being, the promise of political stability paired with EU funding support has boosted consumer and economic sentiment. Milan remains an economic outperformer in our forecasts relative to other Italian cities,[1] supporting stronger rates of rental growth for almost all real estate sectors.

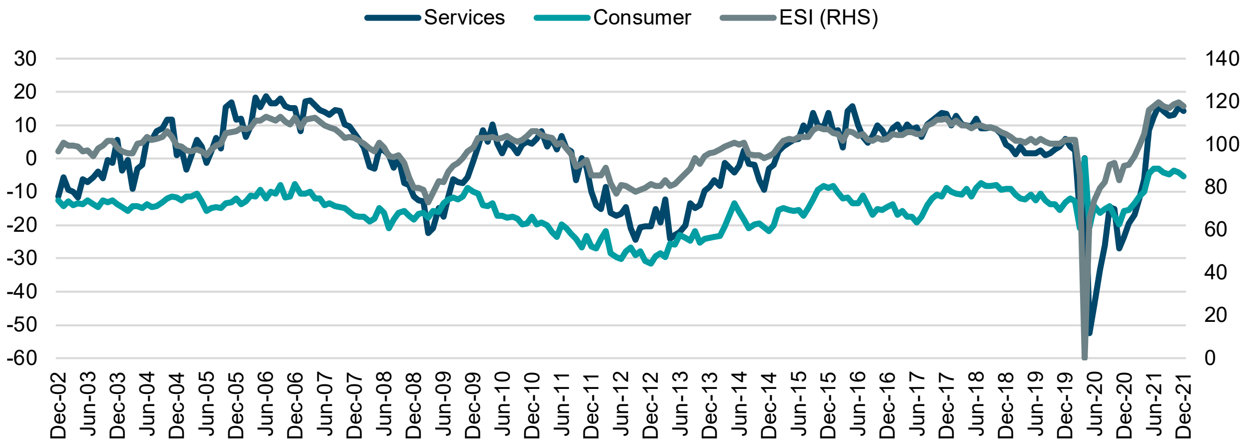
The real estate market in Italy has presented a mixed bag of performance over the past year. Investor demand for logistics has been unprecedented, resulting in a 50-basis point reduction in prime yields in both Milan and Rome during the first three quarters of 2021.[2] Offices present a more nuanced picture. Prime product in the CBD remains in demand from both investors and occupiers, causing further yield compression, but waning tenant demand for secondary offices has led to a fall in values. A lack of modern office stock in Milan and a clear occupier preference for grade A buildings suggest a focus on refurbishment. However, this is a popular strategy with developers in Milan and we expect short-term supply growth to constrain rental upsides.

Investor caution around the hotel sector brought about some pricing weakness early in the pandemic, but a resurgence in tourist numbers in the second half of 2021 resulted in yields returning to pre-pandemic levels. In the retail sector, prime

[1] DWS, Oxford Economics, December 2021
[2] PMA, Q3 2021

shopping centre rents fell for the first time in 2021 and with vacancy almost 30% higher than 2019 levels, we expect further rental decline over at least the next two years.

Italy Sentiment Indicators



Source: European Commission, January 2022

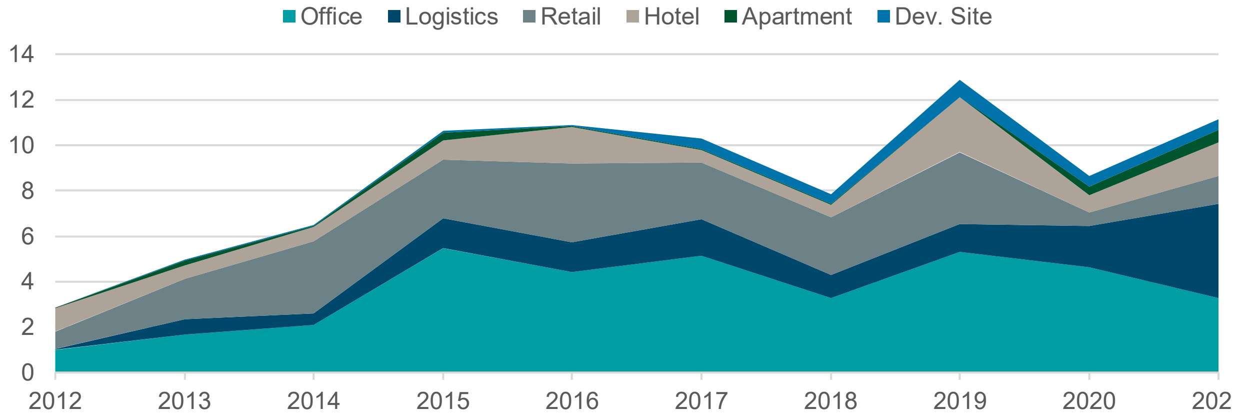
Logistics yield compression exceeds expectations

Logistics has been a top performer over the past year. Investment volumes for the sector surpassed offices for the first time in 2021,[3] and yield compression exceeded expectations. We expect annual prime total returns for Milan and Rome (5.4% and 5.5%, respectively) to remain slightly above the European average (5.0%) over the next ten years, despite a narrowing of the yield spread. Assets located close to urban populations are likely to see higher levels of rental growth, benefitting from low levels of new supply and strong demand from logistics occupiers looking to serve consumers directly. Most logistics stock does not meet current occupier standards, presenting an opportunity to benefit from growing rents and capital values through new development.

Within logistics, we also see investment potential in cold storage. As cold storage warehouses tend to be around twice as expensive to develop as dry storage, it is rare for developers to build this type of warehouse on a speculative basis, while lease lengths are often considerably longer than for standard warehouses.

[3] RCA, January 2022

Investment Volumes (€ Billion)



Source: RCA, January 2022
Note: F= forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

Student housing a key focus within residential sector

Residential remains a growing area of interest but the market is still in an early stage of growth. Deployment of capital at scale is therefore hampered by a lack of investable stock. Our expectations for rental growth in Milan are slightly below the European average for the sector due to weaker household disposable income growth, meaning that prime total returns are also forecast to underperform the European residential average over the next ten years.

Student housing may offer more attractive opportunities. The Italian student housing market is undersupplied relative to student numbers, and existing purpose-built stock is generally of low quality. These factors, together with increasing student numbers, should support strong rates of future rental growth. Development opportunities should be assessed according to the quality of amenities offered and, more importantly, proximity to the campus of a high-ranking university, which tends to appeal to international students.

Some recovery in the hotel market

The window of opportunity to capture temporary weakness in hotel pricing is now largely closed as prime yields have already recovered to pre-pandemic levels. The Italian hotel market saw a quick resurgence in visitor numbers after travel restrictions were eased last year, giving confidence that it remains a desirable tourist destination.

A return to pre-pandemic visitor numbers is likely to take at least another year due to Italy's popularity with international tourists, particularly from the U.S., who are more hesitant to travel long haul given the current risks around travel restrictions. The Italian hotel market remains highly fragmented, with large numbers of small and regional operators. There may therefore be opportunities to develop and support the expansion of international operators.

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