Real Estate
Research

March 2023

Italy Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

- While prices adjust to accommodate higher financing costs, the Italian real estate investment market has been exceptionally quiet, with the lowest fourth quarter transactions volume for a decade.
- Repricing in logistics may offer a window of opportunity to acquire assets within growing markets in northern Italy for a more attractive yield. Residential – a nascent but increasingly investable sector in Italy – also looks attractive, with student housing and co-living particularly undersupplied relative to demand.
- A value-add strategy for office could be applied selectively in central, supply-constrained locations within Milan and Rome to bring dated stock up to the latest regulatory and occupier standards.

Economic performance surprised on the upside in 2022, although bond yields and borrowing costs rose sharply in the second half of the year. Real estate transaction activity fell away sharply towards the end of the year, with fourth quarter volumes down by more than 50% year-on-year, and well below the historical average.[1] As such, while real estate yields were perhaps slower to respond than in other European markets, we have now seen a significant price adjustment. For some parts of the market – particularly logistics – we believe that the repricing is now complete. However, for other sectors we expect some further yield shift early this year, with capital values bottoming out by mid-year. This may present an opportunity to acquire assets in sectors such as residential and logistics, where record low yields had become difficult to justify relative to expected rental growth over a five or ten-year outlook. In addition, we see scope to acquire and refurbish dated and energy-inefficient office stock in supply-constrained locations in Milan and Rome, creating assets that meet the latest occupier standards while realising significant rental uplift and minimising letting risk.

Recession likely to be short

The Italian economy was given a lift in 2022 by a strong rebound in tourist numbers, while domestic demand also supported GDP growth, resulting in better-than-expected performance in the first three quarters of the year.[2] However, the final quarter of the year is likely to have seen a marked slowdown as the effects of higher energy costs fed into reduced household incomes and spending. The right-wing led coalition government that was formed in October 2022 has promised to continue fiscal support measures to smooth the impact of a spike in energy costs on household incomes, so we expect any contraction in the economy to be mild and relatively short lived.

In the medium-to-long term, the Italian economy is not a market we expect to outperform. Although the €235 billion Resilience and Recovery Plan (RRP), which links EU funds with national commitments, has the potential to put the economy on a path to higher growth, the

[1] RCA, January 2023
[2] Reuters, October 2022

likely impact of these funds is limited by the government's poor track record in absorbing and spending such funds, as well as persistent structural economic issues. The female labour participation rate, for example, is just 56% (20 percentage points lower than that of males), despite similar educational attainment rates.[3] In addition, the high debt-to-GDP ratio gives the government limited fiscal power to stimulate growth and boost aggregate demand. However, the key cities of Milan and Rome are expected to grow faster than the national average,[4] and are therefore our main focus for investment.

Affordable residential looks increasingly attractive

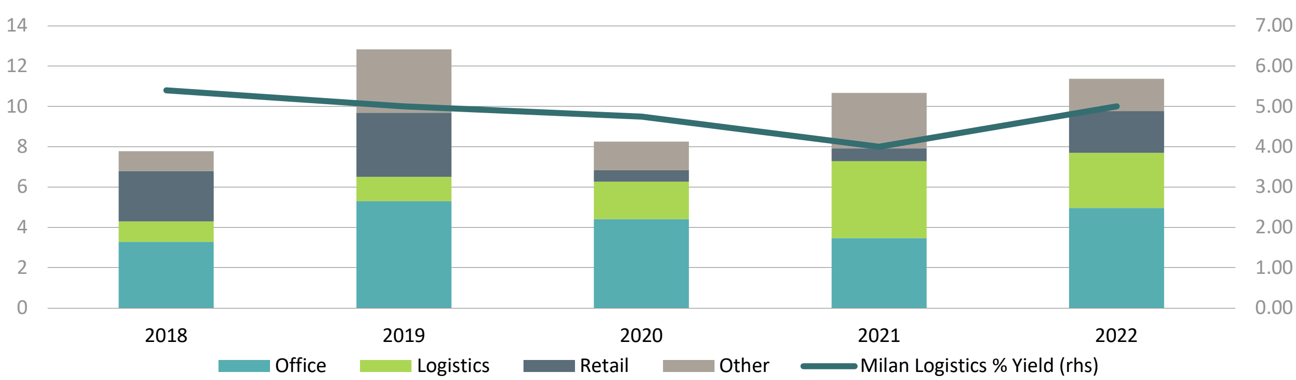
In each of the past three years, annual investment volumes in the Italian residential market have been more than three times higher than the average of the previous 10 years,[5] pulling yields well below 3.00%. While there has been some correction in pricing towards the end of 2022, we still see limited opportunity for investment in the prime segment at current prices. However, the investment story for affordable residential in Milan is more convincing. Here, economic growth is buoyant and demand for rented property is strong, as the city attracts young professionals, who are more likely to look for accommodation in the rented sector. Furthermore, this may create an opportunity for investment in co-living, another growing residential sub-sector.

The student housing sector is also attractive. Italy is currently undersupplied for student accommodation (the provision rate is just 4%)[6] and the standing stock is dated and fails to meet the standard of modern stock we are familiar with in more mature markets such as the UK. Again, Milan is the main focus for new development and investment, but regional cities with an established, high-quality university offering, such as Florence, Bologna, Pisa and Turin, could also be interesting.

Repriced logistics a tactical investment opportunity

Until last year, one of our key investment calls for Italy was the logistics market, based on a strong outlook for the occupier market, low vacancy (currently below 3%)[7] and attractive pricing relative to most other European markets. Two years of record-breaking investment in 2021 and 2022 have narrowed the price gap further and weighed on the performance outlook, and we are now forecasting returns to be similar to the European average over the next 10 years. However, we still expect higher rental growth for urban logistics, particularly around Milan where supply is constrained and a relatively affluent local population supports consumer spending, and therefore occupier demand for logistics space. The dated nature of much of the stock around Milan, particularly for urban logistics, suggests a value-add strategy would be appropriate in this location.

Italy Transaction Volumes (€ billion) and Prime Logistics Yield (%, rhs)



Source: RCA, PMA, DWS, January 2023.

[3] Oxford Economics, January 2023
[4] Oxford Economics, January 2023
[5] RCA, January 2023
[6] Savills, August 2022
[7] Colliers, November 2022

Our outlook for the Rome logistics market is less positive. While modern space is in short supply, the Rome logistics market is only suitable for operators serving the domestic market in Southern Italy. In addition, the available consumer spend within a four and a half hour drive time of Rome is approximately half that of Milan,[8] so the required logistics space to serve this market is lower. Occupier demand is therefore likely to be weaker, dampening our expectations for rental growth.

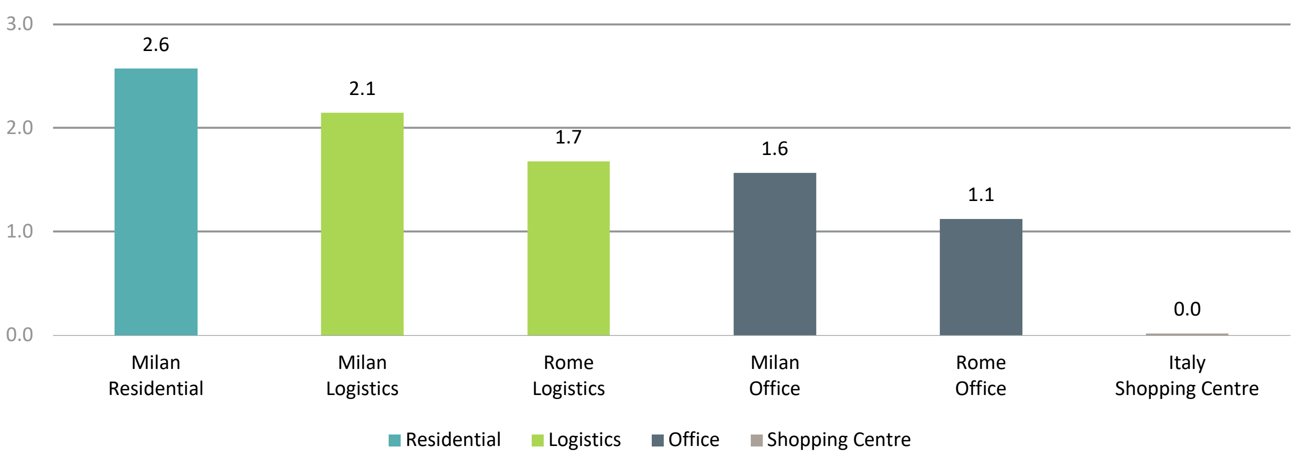
Opportunity in value-add office strategy

For most of 2022, the Italian office market appeared immune to the effects of rising borrowing costs across Europe. However, as the fourth quarter progressed, evidence of repricing started to come to light, signalling a significant change in the market. Recent examples include Macquarie's acquisition of a Milan office in November 2022 at a discount of 15-20% to the price initially expected.[9] This year, we expect some continuation of this correction in values, bringing the overall change to around -20%.

The occupier market enters the current period of economic weakness after a strong run of performance. Prime offices enjoyed rental growth of almost 5% per annum over the past five years, and take-up in Milan during the first three quarters of last year almost matched the levels achieved in 2019, a record year.[10] However, much of this activity represents relocations and consolidation into new or refurbished sites rather than expansion. The bank Intesa Sanpaolo's pre-let at MilanoSesto, consolidating its operations from several sites into one complex, is one example.[11] The concentration of occupier demand in grade A stock has left a long tail of obsolete space. An estimated 14% of the office market in Milan and Rome is currently vacant,[12] and this is a significant drag on rental growth for non-prime stock.

The mismatch between supply and demand represents an investment opportunity, particularly following the price correction of 2022. In Rome, only 15% of current stock was built in the past 20 years[13], and with EU regulation regarding energy efficiency tightening, there is a real need to upgrade much of the current stock. Milan shares this issue, albeit to a lesser extent. A secondary strategy for the coming year will therefore be to source and renovate existing office buildings to meet current occupier standards and future energy efficiency requirements.

Prime Rent Growth Forecast, 2023-2032f (% p.a.)



Source: DWS, January 2023. 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.

[8] PMA, October 2022
[9] REACT News, November 2022
[10] PMA, December 2022
[11] PMA, December 2022
[12] PMA, December 2022
[13] PMA, Spring 2021

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