Real Estate House View

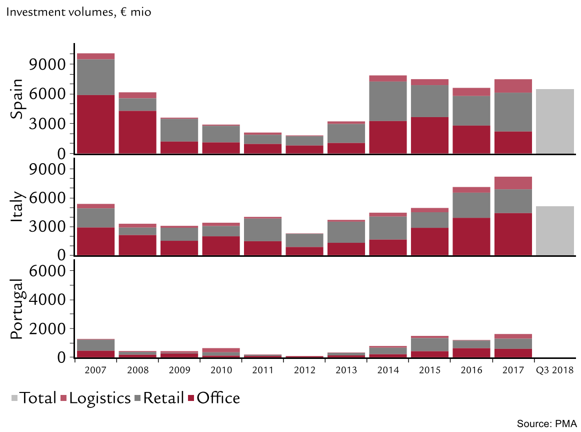
Italy, Spain, Portugal

First half-year 2019

Key takeaways

- The office market in Southern Europe proved solid in its core cities of Madrid, Barcelona and Milan, despite some political turbulence. Demand fundamentals are strong with take-up levels above their 10-year average, limited volumes of new supply and, as a consequence, falling vacancy rates.
- These markets offer a diversified tenant base and are attractive to young talent and expats, and rents in Spain are still cheap from a European perspective. These elements tick the boxes for a strong investment and letting market.
- International retailers are reinforcing their presence in the centre of large cities by opening flagship and concept stores targeting affluent consumers, both tourists and locals.
- Revenue Per Available Room (RevPAR) in the Southern European hospitality sector is expected to increase by 3% on average in the main cities. Overnight stays by tourists are also expected to reach a new record high. In this context, investors are competing to deploy capital in the hotel sector but assets are increasingly rare.
- The housing market was fuelled by international capital and income growth over the past few years. House prices in coastal areas are expected to continue to increase over the medium term unless a disorderly Brexit halts part of the international capital inflow.

Chart in focus



Investment volumes in Southern Europe are expected to be high in 2018 (Portugal data missing at point of writing) with Spain almost reaching its full year 2017 investment volume. Italy is still holding up despite current political events. This is mainly due to the retail sector, for which national and international investors have continued to show a healthy appetite. In both countries, 2018 volumes are expected to surpass their 10-year average.

The anti-establishment coalition government in Italy confronted the pro-European group with a budget proposal, which is not compliant with Maastricht criteria. As a consequence, sovereign credit spreads for Italy widened substantially, causing lending conditions for the private sector to tighten as well. While public support for the government remains strong, economic dynamics have clearly deteriorated. Italy is the only country in Europe where the purchasing managers' index (PMI) in the manufacturing sectors dropped below the 50-points expansion line. Meanwhile, Spain and Portugal – two countries which have more meaningfully embarked on economic reforms – continue to harvest the fruit of earlier efforts. So far, sovereign credit spreads for these countries have only widened marginally, suggesting limited contagion from Italy's budget crisis. Yet, forward rates indicate that fixed-income markets are preparing for rising sovereign bond yields in Spain and Portugal in response to the end of the ECB's asset purchase programme.

A diverse office occupier base

Office markets in Barcelona, Madrid and Milan proved resilient in early 2018 despite some political instability. In Madrid and Barcelona, new office jobs grew 2% in 2017, and this growth rate is expected to continue in 2018 and 2019. Office take-up is therefore high, with almost 100,000 sqm let in Madrid every quarter and 75,000 sqm in Barcelona – respectively 20% and 50% higher than their 10-year average. Moreover, net additions are low and vacancy rates fell to 8.7% in Barcelona and 9.7% in Madrid – down 200 bps and 100 bps respectively compared to Q3 2017. In the CBD, vacancy rates are even lower: 1.5% in Barcelona and 4.1% in Madrid, reflecting tenants' increasing wish to relocate within the city centre. The two cities are attractive to investors as their occupier base is diverse, rents are low compared to other European cities and they are appealing to young talent and expats. In Italy, Milan's GDP growth is put at 1.9% for 2018, outperforming the national rate of 1.1%. As a result, take-up is robust, averaging 74,000 sqm let per quarter in 2018, above the 10-year average. However, demand for offices in Milan is mainly driven by relocation with high pre-let activity. Numerous buildings are dated and tenants are demanding new-generation buildings that match new working models such as flex-office and integrated services. In this context, there are opportunities in the city in repositioning assets. Finally, the city benefits from a very diversified occupier base (95% private sector).

Retail stronger in large cities

In Spain, Italy and Portugal, high street retail in large cities is outperforming the shopping centre submarket. The most touristy cities are posting strong rental growth whilst rents per sqm for retailers remain low compared to other European cities. International retailers have opened flagships and concept stores in key high streets in Madrid, and in secondary streets in Milan and Lisbon, targeting wealthy tourists. Madrid and Lisbon have registered the highest rates of tourist growth: from 5% to 8% p.a since 2014. Although the high street shop submarket is in good shape, rental values in other formats remain below their peak. Pan-European shopping centre REITs have continued to rationalise their portfolios. In the shopping centre submarket, proactive management, including the rotation of brands, is essential to attract shoppers.

Hotels as attractive assets

RevPAR (Revenue Per Available Room) is set to rise by an average of 3% in 2018 in all main Southern European cities as overnight stays are set to reach a new high in Spain and Portugal. Most investors are targeting Italy, Spain and Portugal alongside Germany and France, and these countries make up almost 78% of total nights spent in Europe. However, assets are rare and the rules governing the conversion of offices into hotels are becoming stricter. Prime yields are between 5% and 5.5% and pricing is expected to harden further, sustained by stable and strong income streams.

Housing in good shape

The residential market has proved dynamic over the past few years. Strong demand from private foreign capital has fuelled housing price growth in high-end districts. Performance across these three countries will continue to vary between cities, given the sharp differences in income growth. House prices in coastal areas will continue to recover, although a disorderly Brexit might have a second-round effect and put pressure on prices.

Chart 1: Office rolling annual takeup

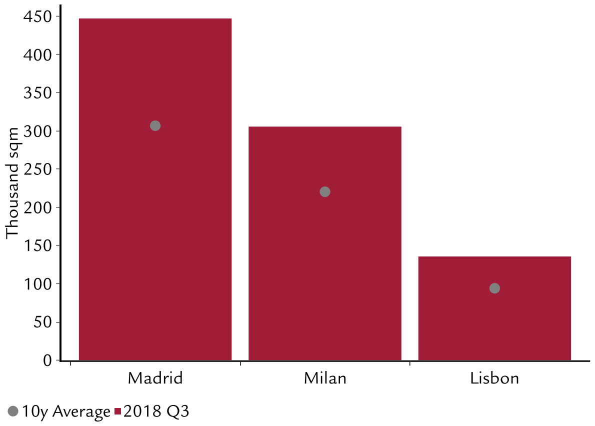
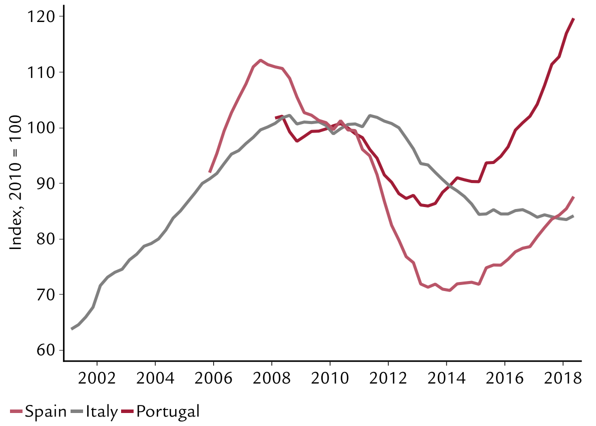


Chart 2: Housing price index for Southern Europe



Authors

Swiss Life REIM France

Béatrice Guedj
Head of Research and Innovation
beatrice.guedj@swisslife-reim.fr

Charlie Jonneaux
Investment Analyst
charlie.jonneaux@swisslife-reim.fr

Swiss Life Asset Managers

Francesca Boucard
Economist Real Estate
francesca.boucard@swisslife.ch

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch

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