Real Estate House View

Italy, Spain, Portugal

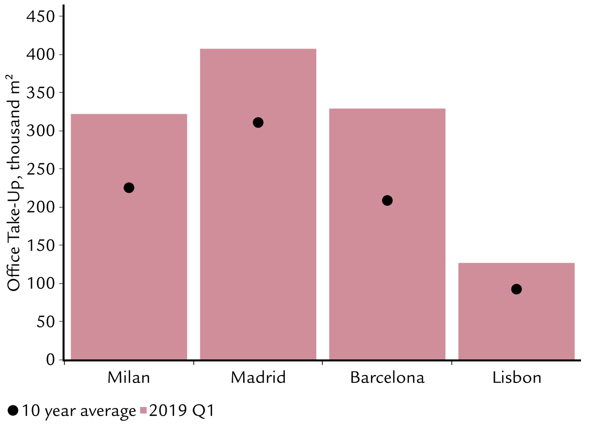
SwissLife
Asset Managers

Second half-year 2019

Key takeaways

- Office markets in Southern Europe were characterised by strong rental activity in Q1 2019. Take-up is on the rise and vacancy rates are heading lower as net new additions remain modest. As a result, rental values keep growing.
- In Barcelona, a new business district named 22@ is attracting more and more tenants and investors. The city of Barcelona as a whole is attracting local and international “tech” companies, which find a highly skilled labour force, good life quality and an international environment.
- High street retail assets continue to concentrate retailers’ demand, high purchasing power and traffic from both domestic and tourist shoppers. As such, high street total returns continued to outperform the retail sector as a whole.
- Hotels are gaining in popularity: Spain, Italy and Portugal account for 43% of total nights spent in continental Europe, hence the appetite of international investors for these alternative products. The sector benefits from positive expectations regarding Asian tourists’ growth in these destinations. Given also the potential to build a portfolio with a wide range of products, locations across these countries are seen as a key advantage by investors.

Chart in focus



Source: PMA

Rental activity in Southern Europe has been particularly dynamic over the past few years. Letting activity in all four main office markets in this region are above their 10-year average. The drivers of take-up differ between the countries though. In Milan, tenants tend to leave obsolete properties to relocate in recently refurbished properties. Barcelona benefits from large tech companies – such as Amazon, WeWork or Criteo – installing their technical and sales teams in the city.

The landslide victory of the Lega party in the European elections strengthened Matteo Salvini's position in the Italian government. By pushing for an expansionary budget, he put Italy back on a collision course with the EU Commission, but ultimately yielded to EU demands. Nevertheless, the conflict is set to erupt again, and financial markets remain wary. Yields on Italian sovereign bonds have receded far less this year than its counterparts in the European periphery. Economic confidence is thus suffering both among consumers and corporates, and we continue to expect very sluggish growth in Italy over the period ahead. Meanwhile, Spain and Portugal, who have had their fair share of reforms, have regained investors' confidence, with government bond yields dropping to new all-time lows. The unemployment rate continues to decline in these economies and underpins a robust domestic economy, even as the manufacturing sector is reeling from the global cyclical downturn. Overall, GDP growth in both Spain and Portugal has so far only slowed moderately to an annual pace of more or less 2%.

Dynamic rental activity

Strong rental activity in Q1 2019 characterized Southern Europe. The rolling annual take-up grew in most markets: by 11% in Milan (Q4 2018), 17% in Barcelona and 6% in Madrid. Thus vacancy rates keep heading downwards in these cities, with the Milan CBD vacancy rate standing at 5.9% as at Q1 2019 (-100 bps in a year) and the Madrid CBD at 6.7% (-150 bps). In Barcelona, the vacancy rate in the New Business District (NBD) dropped to 1.9% from 2.5% in a year, reflecting the area's attractiveness. This dynamic rental activity is pushing prime rents higher. In Spain, prime rents stand at EUR 411 per sqm in Madrid (+4% in a year) and at EUR 324 per sqm in Barcelona (+13%). The rental growth in Barcelona is fuelled by the rise of the NBD, which is attracting large IT covenants such as Amazon, WeWork, Criteo and King. These companies find high-quality buildings and a highly skilled workforce from all over Europe that is attracted by the city's quality of life.

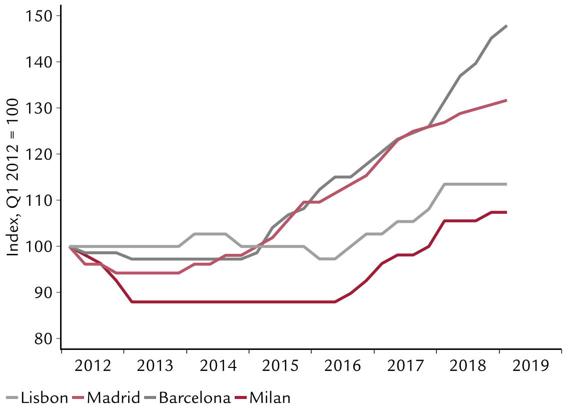
Concentrated retail performance

Retail markets remain highly variable across different locations and sectors. Spain, Italy and Portugal are very diverse in terms of online shopping compared to other European countries. High street retail in large cities is a strong anchor for "retail therapy" and benefits from business and leisure tourism traffic. On the negative side, rising supply in the shopping centre submarket in the past explains the declining gains in both income and capital returns. Madrid, Barcelona, Milan, Florence, Rome, Lisbon and Porto are popular destinations for retailers: although rental growth is set to slow, these cities will continue to buck the national figures. Footfall and spending growth from affluent locals and tourists continue to fuel turnover at prime locations. By contrast, in medium-sized cities rental values in shopping centres and retail warehouses are still 10–20% below their peak on average. These assets are highly sensitive to spending by local shoppers, which is still being constrained by high unemployment.

More diverse hotel clientele

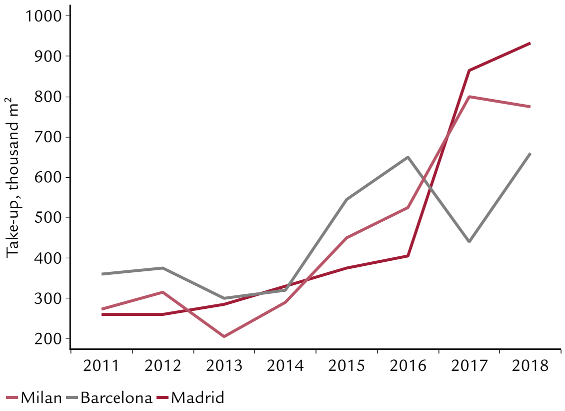
Nights spent in hotels in Europe are on the rise in Q1 2019. Among the top southern destinations, Italy saw the largest rise in Q1 2019 at +1.8% while Spain remained stable and Portugal decreased by 2%, pausing after growing by an impressive 7% p.a. since 2012. This decrease, more specifically in the south of Portugal, was mainly driven by fewer British citizens coming due to the depreciation in sterling and Brexit uncertainties. On the positive side, Asian tourist flows increased at both historic and coastal locations in Spain, Italy and Portugal. In 2018, the hospitality sector posted strong gains in terms of income and capital returns, as released by MSCI last April. Given the strong prospects for Asian (and especially Chinese) tourism in the next decade, the sector is continuing to benefit from positive expectations and investors' appetite. The diversification of demand between European and non-European tourists is giving rise to a wider range of products, from niche luxury hotels to 3- and 4- star hotels, in various locations. On top of that, both leisure and business demand in a country like Italy – the second in term of nights spent in Europe after Spain – makes the country an interesting target for risk diversification. Regarding the imbalances between demand and supply, both Spain and Portugal are seeing a shift from office to hotel-related uses. This could deliver attractive returns in the medium term. Prime yields are hovering between 5% and 5.5% from Barcelona to Milan. Pricing is expected to harden further on the back of stronger income.

Chart 1: Office prime rents index still on the rise in Southern Europe



Source: Cushman & Wakefield

Chart 2: Logistics take-up keeps growing in main Southern European cities



Source: PMA

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