Real Estate House View

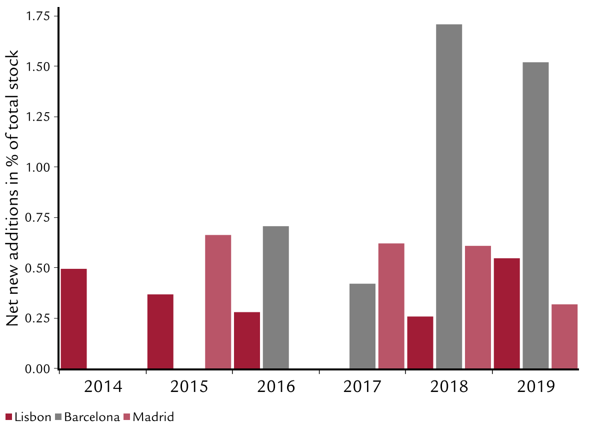
Italy, Spain, Portugal

Second half-year 2020

Key takeaways

- **Southern European office markets** are predicted to experience a decline in occupier demand, but the situation varies across cities. Some submarkets will perform better than others due to their exposure to technology, outsourcing or other sectors in which occupational demand remains strong. Examples include 22@ in Barcelona and central Lisbon. Other submarkets which rely on more traditional industrial companies may experience lower occupational demand.
- **Retail in Southern Europe has been hit hard** by the lockdown. Shopping centres have been particularly badly impacted relative to high street convenience stores. The lack of tourism is preventing a short-term turnover recovery.
- **Hotel nights spent in Southern Europe reached an historic low** from March to June. No recovery is in sight as inbound tourism remains low, especially for high spending American and Asian tourists. Ongoing concern over future pandemic waves is adding further pressure to the sector leading to rising yields.

Chart in focus



Source: PMA

Contrary to the GFC economic shock which occurred at a time of extensive development activity in Southern Europe, net new additions in the upcoming years are at a low level of below 2% for most cities. The limited level of new supply will be likely to restrict the potential for rising vacancy and the volatility of ERVs. The fundamentals of Southern Europe are stronger than in 2008 and the expected economic recovery – especially in the Iberian Peninsula – should create opportunities for growth in these markets.

Italy and Spain have suffered particularly badly from the pandemic with a high loss of life and a sharp economic collapse due to the length of implemented lockdown measures which have only recently been relaxed. An unfavourable sector composition with a high number of jobs dependent on the ailing services industries suggests that overall economic activity will not recover to pre-crisis levels before 2022. The EU agreement on a European recovery fund is a positive signal to rebuild confidence in southern Europe's banking system and the faith of the single currency. Structural reforms undertaken in Portugal and Spain following the European sovereign debt crisis and the resulting improved competitiveness may now benefit these economies as they provide protection from slowing global trade headwinds.

Target Technology-centric Cities

Comparable to other European countries, office investment and rental activity fell during the pandemic. Across the region, some cities will perform better than others. Barcelona is expected to see limited adverse impacts as a significant component of occupier demand emanates from the technology sector. Amazon has continued to extend its offices in Barcelona, for example, their only European office to see a major headcount increase during the pandemic. This example shows the benefit of cities exposed to the technology, healthcare and other essential production sectors. Lisbon also attracts large European companies that are outsourcing customer services, given its highly skilled workforce, lower wages and attractive quality of life. Overall, large cities in Spain and Portugal are expected to see sustained long-term demand once the short-term shock fades. Italy will benefit from the European recovery plan which is likely to stimulate interior demand and strengthen northern industrial SMEs that have suffered during the pandemic.

Enduring Retail Pain

The lockdown hit hard bricks-and-mortar businesses in Spain and Italy with average falls in turnover of -16% to -25%. Impacts were far more severe in tourism-based locations. Rent collections rates are below 50% in many shopping centres while some investment transactions were cancelled. The current crisis is amplifying existing weaknesses across locations and business models. Online retail penetration surged to historically high levels in both countries, enabling some fashion brands to weather the storm or accelerate their *phygital* transformation. Restrictions on travel are dampening luxury brands in some locations such as Madrid, Barcelona, Sevilla, Majorca, Milan, Florence and Rome, as Asian and American tourism has halted. Retailers seeking to renegotiate rents with landlords responding to these requests on a case-by-case basis. The forecast consumption recovery is not expected to mitigate past trading losses across the retail spectrum. Therefore, vacancy rates are set to rise from store closures, pushing down rental values and driving up yields. Inditex, the Spanish retail group has announced it will shut down 16% of its worldwide portfolio, with rationalisation in Spain, Italy and Portugal. Convenience stores are expected to be more resilient. Investor appetite for core retail products may stay on hold. Opportunistic and cash-rich investors are expected to seek repositioning opportunities and for alternative uses in both the shopping centres or the high street segments when prices are perceived to have bottomed out. The retail sector will remain weak for some time, increasing performance polarisation.

Hospitality is Most Vulnerable

In the 3 months to May 2020, occupation rates for hotel accommodation reached historical lows. Compared to the same period last year, the total number of overnight stays accounted for only 10% of levels in Spain, 7.5% in Italy and 13% in Portugal. The market remains weak given the low level of air traffic and second wave fears. Spain is the most exposed due to its higher dependency on hospitality. Luxury resorts in Spain, Italy and Portugal are set to remain closed until the end of the year due to their dependency of non-European hosts. Mid-range hotels are in a better position once tourism inflow resumes. Across the sector as a whole, occupation rates are set to remain extremely low in the short term. Landlords, operators and local authorities across Southern Europe are exploring long-lasting strategies given the contribution of the tourist industry to national GDP. Investment in hospitality has accounted for a large property of foreign capital inflows over the last few years to these countries. As credit conditions steepen, highly leveraged investors might become forced sellers.

Chart 1: Limited yield movement across Southern European markets

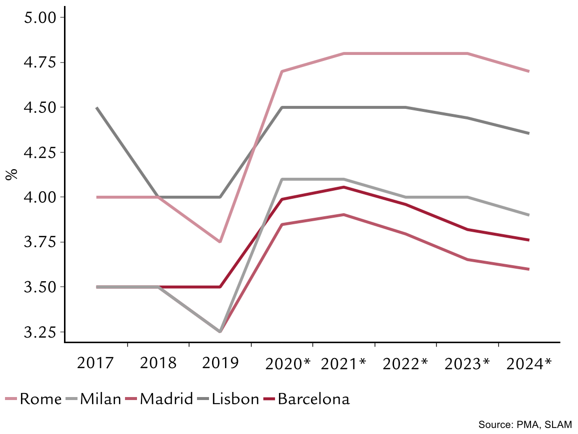
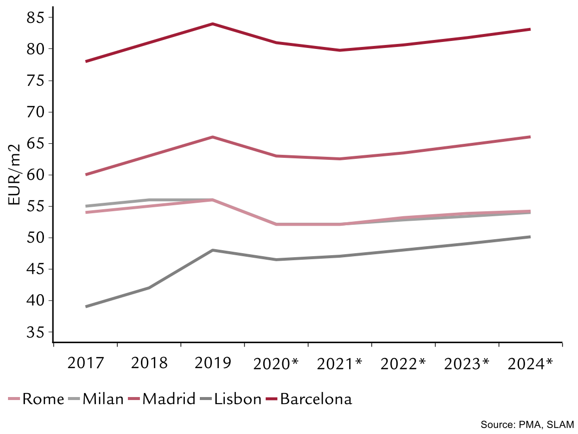


Chart 2: Logistics Prime rental growth will resume from as early as 2021



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