Real Estate House View

Italy, Spain, Portugal

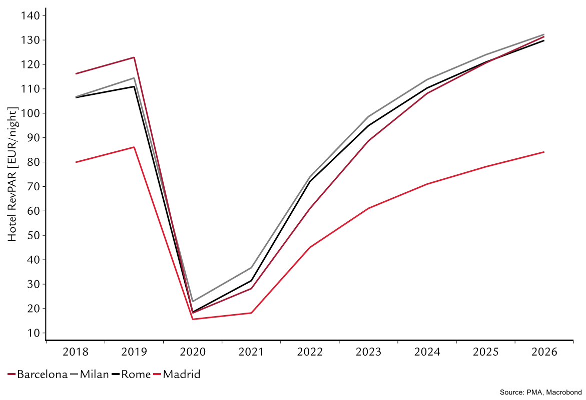
Swiss Life Asset Managers

Second half-year 2022

Key takeaways

- **Office:** The upturn in rental activity in the central districts of the large cities was marred by the Ukrainian crisis due to the uncertainties generated in terms of the scale and duration of the downturn. On the investment market, the risk premiums are already swaying due to the increase in interest rates. The experience of the sovereign debt crisis remains a painful memory explaining the very defensive position of investors.
- **Retail:** Following an initial six months supported by tourism activity, the trend towards precautionary saving is intensifying. The double-digit inflation is drastically cutting purchasing power. The increased vacancy rates are unlikely to decline as long as the headwind persists.
- **Hospitality:** The sector has benefited from a major influx of European and American tourists in 2021. However, the downturn in real disposable household income will weigh on the sector by way of shorter stays.
- **Logistics:** The star sector could take a break in some locations and sectors in the wake of the downturn in foreign and domestic demand due to the fall in consumption. The yield compression is indeed over and there could be a very sharp rise if speculative projects fail to attract buyers.

Chart focus



Tourism has been gradually picking up strength since the end of 2021. Occupancy rates at hotels have bounced back, although at national level they remain on average 30% to 40% below their pre-crisis level according to property type and location. On a positive note, long-term investors remain present at key destinations, although the gradual recovery expected in 2023-2024 will be offset by the fall in purchasing power. Hoteliers are currently absorbing the rise in prices in order to remain attractive. Ultimately, however, the double-digit inflation will weigh on the RevPAR if households adopt a precautionary attitude by reducing the average duration of their stays.

With the normalisation of monetary policy, including that of the European Central Bank (ECB), the risk of fragmentation or a break-up of the eurozone has returned. It will now be necessary to see whether the economic reforms in Portugal and Spain have enabled them to improve their resilience. The economic and political situation in Italy is proving particularly fragile. The effectiveness of the ECB's attempts to prevent a sharp increase in the risk premium on the sovereign bonds of countries in the south of the eurozone will be put to the test again in the months to come. Elections will take place in Italy by next spring at the latest. In the meantime, the political upheaval could further reinforce the uncertainty.

Office on a tightrope

The momentum of the upturn in rental activity has been disrupted by the Ukrainian crisis. The polarisation of demand recorded in the central districts of Milan, Barcelona and Madrid at the start of the year, along with a growth in rents, has slowed down sharply since the Ukrainian crisis. Italy is most affected in terms of rental demand due to its dependence on Russian gas. The double-digit inflation level cannot be automatically passed on to tenants in view of the pressures already existing on their profit. The inflation and upturn in interest rates pose a challenge to monetary coherence, as witnessed by the spread of rates for these regions. Risk premiums are falling dramatically as the economic outlook deteriorates. The investment market has dried up due to the fears and expectations of a swifter correction on the markets, which were severely damaged at the last turnaround in 2009. The already increased vacancy rates on the outskirts will continue to rise as the economic difficulties for tenants get worse. Investors are taking a wait-and-see approach, and the growth of the cost of credit has also surged. *"Cash is king"* to benefit from potential opportunities.

Retail on the sidelines

Consumer spending has been supported by the return of European and American tourists. The effect of *retail* therapy has supported the activity of brands in both the large agglomerations and the more tourist areas. Despite the inflation, these countries remain attractive for Northern European shoppers. The headwind is intensifying owing to the problems surrounding the rise in energy prices, and the tourism movement might no longer be able to offset the fall in consumption of domestic shoppers. The level of inflation for these three countries has been historically high since joining the EMU. The trend towards precautionary saving is set to increase, thereby ruling out any chance of recovery for the vacancy rates which have risen from 10% to 20%. Worse still, the rationalisation of portfolios could continue, thereby exacerbating the existing polarisation. The average fall in rents of 20% and more which has taken hold for leases on the prime high streets is set to continue in order to offset the rise in inflation. The major winners of the health crisis such as discount, textile, food and leisure brands are continuing to penetrate secondary towns. On the investment market, the opportunistic strategies of repositioning assets could suffer from the rise in construction costs, which are reaching levels never seen before. However, investors will remain attracted by new price corrections above all in a long-term acquisition strategy.

Logistics trotting

The sector has emerged from the pandemic victorious, with a rise in e-commerce penetration rates in the wake of new consumption methods observed since the health crisis. The multichannel strategy has supported the XXL sector and international e-commerce players expanding their territorial network on the different peninsulas. Supply has for a long time remained limited particularly in the north of Italy, avoiding a downward adjustment in the event of a recession in the manufacturing industry on top of the gas supply problems. Speculative projects in Madrid and Barcelona could push up the vacancy rates if there is a sharp downturn in take-up levels. The rise in production costs in industry and of transport costs in delivery activities is weighing on the indexation potential of rents in some cases. On the investment market, the hype in performance and squeeze on capitalisation rates are now affected by the conjunction of headwinds, including less growth, more inflation and an upturn in interest rates.

Figure 1: Development of prime logistics yields in Italy and Spain

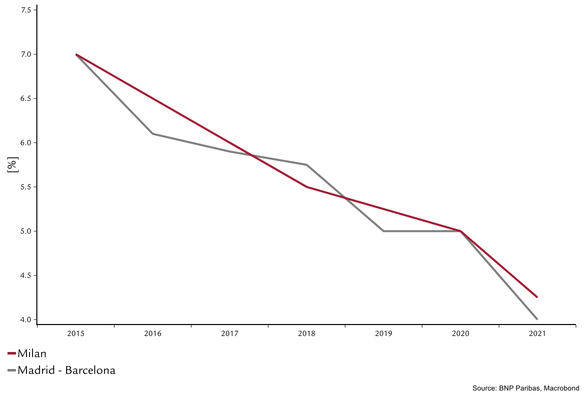
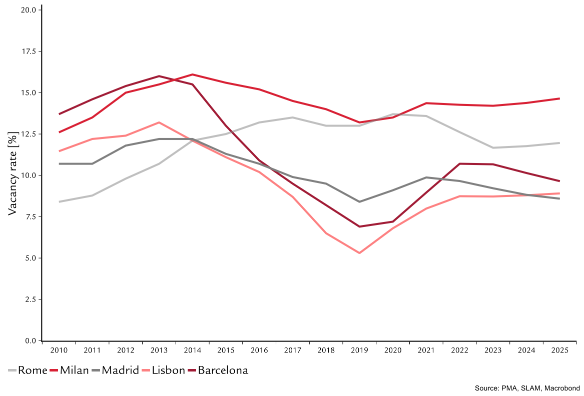


Figure 2: Development of vacancy rates in the office sector



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