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Italian Real Estate Strategic Outlook

March 2016

Investors flocked back to Italy in 2015. While this momentum should continue into 2016, unless the economy can substantially outperform expectations we see a risk that rental growth will not be able to compensate investors for today's lower income returns. We continue to favour retail and logistics over offices. We see shopping centres offering the highest returns over the next five years, followed by logistics. With online sales in Italy growing rapidly but well behind Europe, successful shopping centres and logistics formats in markets such as the United Kingdom and France should provide a useful investment guide.

Record investment led to an exceptionally strong 2015

The Italian market recorded exceptionally high returns during 2015. Having lagged the pick-up in the rest of Europe, prime total returns on offices and logistics in Rome and Milan were close to 20%, and even higher on major high streets.

These returns were driven by investors, who having shunned the market for a number of years, re-entered in droves last year. The end of recession, higher than average property yields and a number of encouraging economic reforms by the government came together to raise investor sentiment. In total, real estate transactions grew 66% last year to €9.7 billion, the highest level on record.[1]

With this, prime yields are now at record lows, having eroded much of the premium over other European markets. While the spread over bonds is still high, and the momentum from last year may continue into 2016, we feel that the positive value impact from yield compression is nearly over.

No shortage of good quality office space

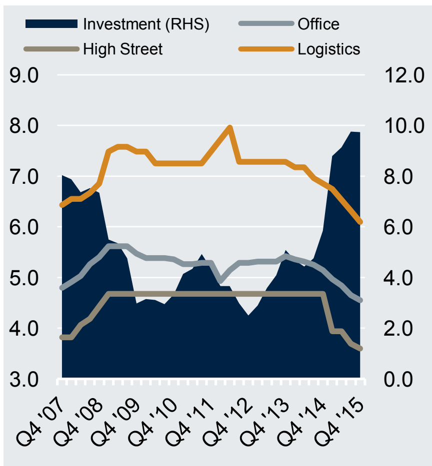
Future performance will be more reliant upon improvements in the occupier market. There have been some signs of this, with office vacancy moving lower in Milan, but in general the occupier recovery is in its infancy.

While recent GDP growth rates have surprised on the upside, the medium term projections remain below the European average. While we see room for GDP growth to outperform these expectations, particularly if the government's reform agenda boosts productivity, in our central case, with no shortage of office availability – even for high quality space – Italian office rent growth is likely to be little more than the European average, and well below strong recovery markets such as Spain and Ireland.

Investment at record high

In the 12 months to end-2015, the volume of commercial property transactions more than doubled in Italy to €10 billion. According to RCA, overseas investors remained the most active purchaser, accounting for almost 75% of all commercial deals done. This rise in investment has clearly had an impact on pricing with prime yields falling by between 50 and 100 basis points.

Investment (€bn) and Prime Yields (%)



Source: PMA, RCA, January 2016.

[1] Real Capital Analytics, February 2016.

We are more optimistic in our outlook for retail. Unemployment is falling and household balance sheets remained fairly strong throughout the downturn. High street vacancy levels within major city centres – not just Milan and Rome – are in low single digits, and prime rents were up by almost 10% last year. While we don't expect this pace of growth to be sustained, we believe an annual average rate of 3% to 4% is achievable over the next five years.

Rent growth has also returned to parts of the logistics sector, notably around Milan. Again the upturn in Italy has lagged other parts of Europe, but with exports rising and e-commerce growing in prominence, we see sustained rent growth of between 2% to 3% over the coming years – well in excess of history.

Shopping centre returns to average near 10% per annum

Over the next five years, offices and high street retail are set to average around 5.5% growth per annum. Despite some of the strongest rental growth, the returns from high street reflect current pricing on this low void risk sector, where prime yields are now less than 4%.[2]

Returns from logistics are set to be above 7%, reflecting both rental growth and a higher income return. Shopping centre returns come out on top. Not only are prime yields in this market still in advance of their long-term average, vacancy rates are now starting to moderate, laying the groundwork for rental recovery.[3]

Late e-commerce adoption; strong future for logistics

The proportion of online spending in Italy is well below the European average at around 3%. However, with growth running at over 20%, we see few impediments to the Italian market converging with the rest of Europe.[4]

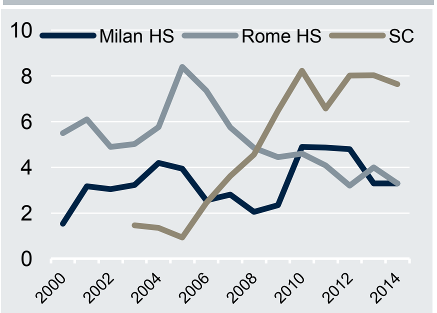
We believe the rest of Europe should act as a guide for investment in Italian logistics and retail.

For example, in places such as the United Kingdom and Germany, e-commerce has had a profound impact upon the logistics sector – boosting overall demand, particularly for large, modern stock and parcel delivery units. Over the medium term, we feel this type of logistics asset should thereby outperform in Italy.

Retail vacancy low on high street

Vacancy rates have diverged since the financial crisis. While shopping centre vacancy rates have remained on average around 8%, the major high streets are around half this level. On the most prime pitches in Milan, Rome and smaller cities like Florence it is growing extremely difficult for retailers to find units, and those that do are often paying a considerable premium for the privilege.

Retail Vacancy Rate (%)

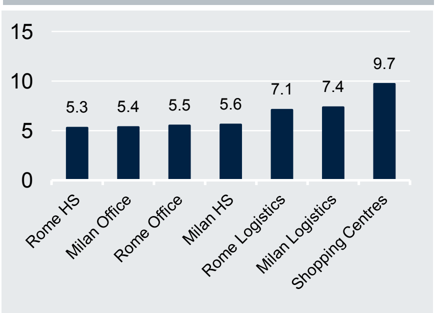


Source: PMA, Cushman & Wakefield, December 2015

Shopping centres outperform

The shopping centre market is projected to outperform other commercial property sectors over the next five years. However, given the expected growth of online retail sales in Italy, we believe this outperformance will be skewed towards the prime segment – particularly the larger regionally dominant centres, which in recent years have typically been the best performing in other parts of Europe.

Annual Average Returns (2016-20f, %)



Source: Deutsche Asset Management, January 2016

[2] PMA, January 2016.
[3] Cushman & Wakefield, December 2015.
[4] Centre for Retail Research,December 2015.

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Office Locations:

Chicago
222 South Riverside Plaza
26th Floor
Chicago
IL 60606-1901
United States

Frankfurt
Tanusanlage 12
60325 Frankfurt am Main
Tel: +49 69 71909 0

London
Winchester House
1 Great Winchester Street
London EC2A 2DB
United Kingdom
Tel: +44 20 754 58000

New York
345 Park Avenue
24th Floor
New York
NY 10154-0102
United States
Tel: +1 212 454 6260

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
Floor 20
One Raffles Quay
South Tower
Singapore 048583
Tel: +65 6538 7011

Tokyo
Floor 18
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
Tokyo
Japan
Tel: +81 3 5156 600

Research & Strategy Team – Alternatives and Real Assets

Global

Mark Roberts
Head of Research & Strategy
mark-g.roberts@db.com

Jaimala Patel
Quantitative Strategy
jaimala.patel@db.com

Americas

Kevin White
Head of Strategy, Americas
kevin.white@db.com

Brooks Wells
Head of Research, Americas
brooks.wells@db.com

Ross Adams
Industrial Research
ross.adams@db.com

Erin Patterson
Office Research
erin.patterson@db.com

Bradley Doremus
Apartment Research
Bradley.doremus@db.com

Silverio Vasquez
Quantitative Research
Silverio.vasquez@db.com

Ana Leon
Retail Research
ana.leon@db.com

Zachery Wade
Property Market Research
zachery.wade@db.com

Europe

Matthias Naumann
Head of Strategy, Europe
matthias.naumann@db.com

Simon Wallace
Head of Research, Europe
simon.wallace@db.com

Tom Francis
Property Market Research
tom.francis@db.com

Farhaz Miah
Property Market Research
farhaz.miah@db.com

Gianluca Minella
Infrastructure Research
gianluca.minella@db.com

Martin Lippmann
Property Market Research
martin.lippmann@db.com

Asia Pacific

Koichiro Obu
Head of Research & Strategy, Asia Pacific
koichiro.obu@db.com

Minxuan Hu
Property Market Research
minxuan.hu@db.com

Natasha Lee
Property Market Research
natasha-j.lee@db.com