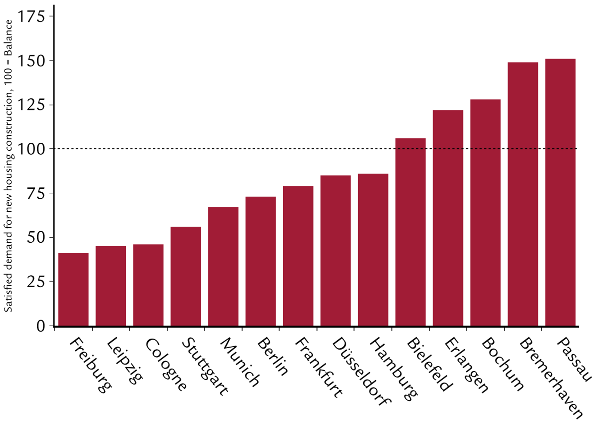
Real Estate House View
Italy, Spain, Portugal

First half-year 2020

Key takeaways

- Rental activity in southern European office markets was, once again, very dynamic in H2 2019. Take-up and rental values are on the rise, whilst vacancy rates and incentives for tenants are heading downwards.
- More than ever, central locations are sought after by tenants and investors. Suburban locations away from transportation and "city life" are suffering from increasing vacancies, stable or lowering rents and stagnating capital values.
- High street retail in southern Europe remains one of the top investment markets, as these countries' retail spending is driven by a better economic situation and a growing number of inbound tourists. Given this, it remains important to focus investment on core locations mixing tourism and national clientele.
- Hotel nights spent in southern Europe increased significantly in a year, despite a lowering number of British tourists visiting these countries. A combination of longer stays all year-round, and increase of national demand, annihilated this slowdown. The sector continues to attract international capital, as investments in hotels reached more than EUR 16 bn over the first three quarters of 2019, as yields still hover between 4.25% and 5% in prime locations.

Chart in focus



Source: German Economic Institute

Rental activity remains the main performance driver for real estate in southern Europe. Take-up in main cities held its 2018 record levels or even overtook them. Take-up is fuelled by both the good tenure of the local economy and the relocation of tenants from obsolete buildings in suburban locations to refurbished assets within the city centres. In this context, vacancy within the core markets is decreasing (e.g. below 4% in Barcelona CBD) whilst suburban locations are suffering from increased vacancy and stagnating rents.

Structural reforms undertaken in Portugal and Spain following the European sovereign debt crisis led to an improved competitiveness that protect these economies to a certain degree from headwinds in the form of slowing global trade. Portugal's economy continues its expansion, although real GDP growth is set to moderate to the slowest pace since 2014. Spanish unemployment numbers started to rise in the third quarter 2019, with this trend expected to continue moderately in 2020. Politics remains the elephant in the room: a renewed widening of Italy's sovereign risk spread to German Bunds forms a major risk in case that a possible general election in 2020 results in the return of a confrontational stance of a new coalition government with the EU Commission.

Rental activity strengthens

Similar to previous periods, the rental activity in southern Europe proved to be dynamic. Take-up in Barcelona was up 23% over the first three quarters of 2019 compared to the same period in 2018. In Milan, take-up was up 18% while in Madrid growth was modest but at high levels from a historical perspective. As a result, vacancy rates continued their downwards shift to reach 7.2% in Barcelona (down 130 bps in a year) and 8.6% in Madrid (down 100 bps). In all southern European cities, vacancy rates are even lower in core locations. For instance, Barcelona CBD and 22@ district display vacancy rates below 4%, a stunning 300 bps gap compared to the city average. Like many other European markets, buildings in core central locations are the winners, attracting tenants and investors and therefore concentrating the growth of capital and rental values. As a result, prime rents keep increasing to reach EUR 590 psm p.a. in Milan (+3.5% in a year), EUR 417 psm p.a. in Madrid (+2.9%) and EUR 336 psm p.a. in Barcelona (+9%). Net new additions remain modest at below 1% of total stock in Madrid, Lisbon and Milan and below 2% in Barcelona. Hence vacancy rates are expected to continue decreasing as a shortage of qualitative space is to remain. This will presumably push rental values higher and reinforce these markets.

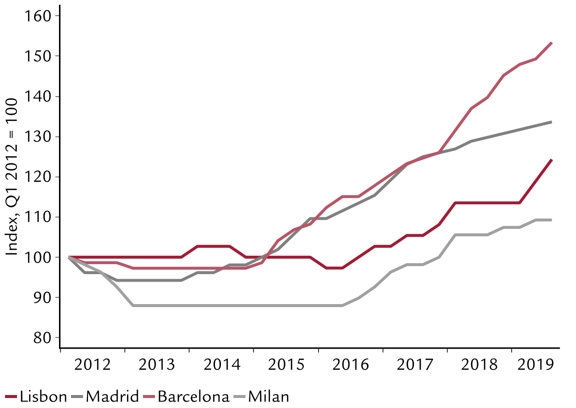
Concentrated retail performance

No visible change in Spain, Italy and Portugal: retail markets remain highly variable across locations and sectors. Retail in large and touristic cities continues to hold well in high street thoroughfares or in convenience shopping areas. Click & collect is getting up to speed as well as smart retail. Footfall and spending growth from affluent locals and tourists continue to fuel turnover at prime locations. Conversely, the shopping centre submarket remains the Achilles' heel in regions with a large floorspace per capita: a cannibalisation effect from new schemes explained the rising vacancy rates in existing schemes. Madrid, Barcelona, Milan, Florence, Rome, Lisbon and Porto remain good bets: although rental growth is set to slow, these cities will continue to buck the national figures, given stronger retail figures. 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 rates.

Hospitality well shaped

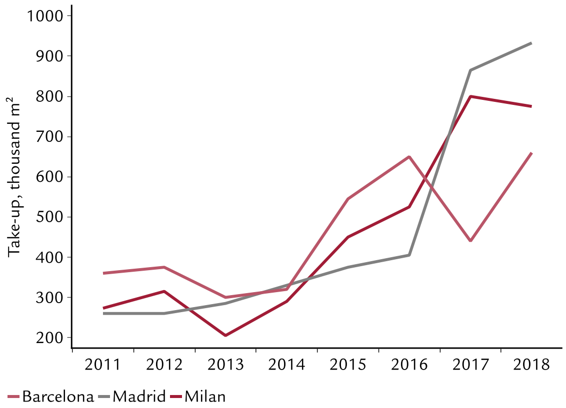
In the nine months to September 2019, hotel investment reached EUR 16.1 bn (almost 9% of overall investment) echoing a strong demand from investors. Macro figures in Europe remained well oriented: nights spent in the nine months to September increased by +15% compared to the same level the year before. Among the top southern destinations, Portugal saw the largest rise in Q3 2019 at +3.6% followed by Spain (+1.2%) while stability was observed in Italy. Foreign demand was lower across all the three countries compared to a year ago: in both Portugal and Spain, the decline in foreigners was mainly triggered by fewer British citizens in the wake of a falling sterling and Brexit uncertainties. Conversely, past increases in purchasing power in both Spain and Portugal fuelled demand in leisure: nights spent by domestic tourists rose by +4% in Spain and +5% in Portugal. As a reminder, in 2018, the hospitality sector posted strong returns in the eurozone: +8.7% according to MSCI. The diversification in demand between European and non-European tourists offers a wider range of products, from niche luxury hotels to 3- and 4- star hotels, in various locations. Regarding the imbalances between demand from investors and supply of products, both Spain and Portugal are seeing a shift from office to hotel-related uses. This could deliver good returns in the medium term. Prime yields are hovering between 4.25% and 5% from Barcelona to Milan.

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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