

Briefing note

Southern Europe: The PIGS are biting back

November 2017



SUMMARY

Different stages of the recovery are leading to different opportunities

■ The investment volume in Southern Europe totalled nearly €13.1bn in Q1-Q3 2017 and is forecast to surpass €19bn by year end.

■ Cross border investors have been more active than domestic buyers accounting for 70% of the investment volume compared to the EU average where cross border investors typically account for 52% of the total.

■ The high street retail sector will be one of the biggest beneficiaries from the rise in consumer spending and tourism.

■ The office vacancy rates are falling due to increasing demand and lack of good quality space in the CBD. This has been putting upwards pressure on rents in Madrid, Milan and Lisbon.

■ The average Southern European prime office yield hardened by 45bps annually (4.65%) by Q3 2017 and has room to compress further, particularly in Portugal and Greece.

■ The growth of ecommerce will lead to increasing demand for logistics and warehouse space which has been lagging in Southern Europe.

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“Positive economic growth, falling unemployment rates and renewed consumer confidence are luring investors back to Southern Europe.”

Alice Marwick, Savills European Research
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➔ **The PIGS are biting back**

Southern European countries have returned to growth after years of high unemployment and low transaction volumes. The unemployment rate, which reached an all time high of 21% in 2013, has been steadily falling and Spain has been leading the recovery largely due to structural reforms the government implemented in 2012. Now, with the lure of strong rental growth and attractive returns, investors are returning to countries once nicknamed the PIGS of Europe.

After years of weak investment activity, the investment volume across Southern Europe has increased by 277% in 2017 compared to the bottom low of €5.2bn registered in 2012, mainly driven by the return of investors to Spain. The total volume in Spain is on course to surpass the long term average investment volume and in 2018 match the historic past peak set in 2007 (€9.9bn). In 2016, Italy took the investment crown and the full year investment volume surpassed the long term average by 54%.

Spain becoming investment destination of choice

During the global financial crisis Spain was considered a risky market but has now become a mainstream investment destination. Distressed assets are increasingly limited in Spain so opportunistic buyers are now looking elsewhere to Portugal and Greece.

The investment volume in Southern

Europe totalled €13.2bn in H1 2017; over 8% higher than the previous year thanks to record investment volumes into Spain. Spain has overtaken Italy to become the most liquid Southern European market and will remain so over the next 12 months. Furthermore, while Italy looks unlikely to match the €8.7bn invested in 2016, the 2017 H1 Spanish investment volume already surpassed the H1 2016 total investment volume by 72% and with approximately €700m worth of assets currently under offer, it will surpass the 2016 investment volume.

The recent declaration of independence by Catalonia's regional parliament resulted in Spain's 10-year government bond yields rising to a year high and the euro falling against the dollar. While the Catalan independence campaign has been grabbing news headlines and may deter investors from investing in the region, this is unlikely to significantly affect commercial investment into the rest of Spain.

Cross border investors driving investment volumes

Cross border investors have been dominating the investment scene directly or through REITs in Spain (Socimis). US funds are favouring Spain over Italy as Italy has been slow to catch up with the Socimis. With the exception of Greece, cross border investors have been more active than domestic buyers accounting for 70% of the H1 investment volume

compared to the EU average where cross border investors typically account for 52% of the total. EU and US funds are the dominant cross border players accounting for 49% and 27% respectively of overseas investment. Asian players have yet to make an impact in Southern Europe, however with the increasing economic stability across the PIGS, this may change in the coming years.

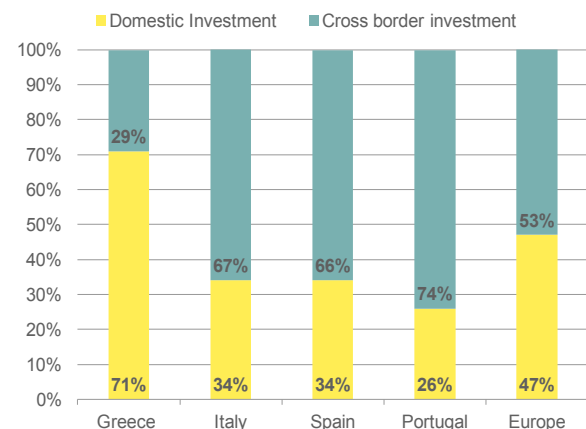
In Portugal, retail has been attracting foreign investors' interest since 2012 with over €3bn invested in retail compared to €1.6bn invested in offices. This year however, offices have overtaken retail with €372m invested in offices compared to €352m retail investment.

Greece is still dominated by local real estate investment companies, however as economic fundamentals improve, international investors will be on the lookout for opportunities, particularly in the hospitality sector.

Southern European yields vastly different

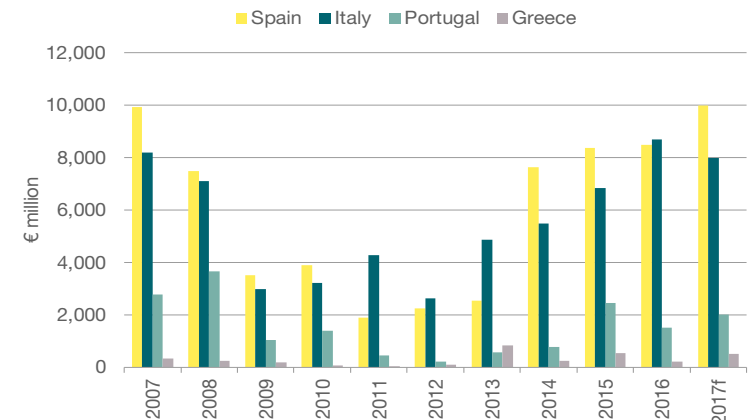
In Spain prime office and retail yields are at a record low (3.25% and 4.25% respectively) and in Italy both office and retail yields have moved in below their past peak. Nevertheless, they are still more attractive than in core markets and they are expected to compress further before the end of the year and stabilise in 2018. The average Southern European prime office yield is forecast to move in by 19bps annually (4.5%) by year end. Additionally some

GRAPH 1 **Overseas investment Q1-Q3 17** Cross border investors drivers behind growth



Source: Savills, RCA

GRAPH 2 **Investment volume** Spain taking the lion's share



Source: Savills, RCA

investors are motivated by attractively priced value-add opportunities in Madrid, Barcelona and Milan.

In Italy, institutional investors have been pushing up the investment volumes and leading yield compression over the past few years. In Lisbon and Athens, prime office values are on an early upswing after the office market hit nadir. Opportunistic investors will focus their sights on Portugal and Greece as yields in the CBD are more attractive and still have room to compress further compared to the core cities in Spain and Italy.

Lack of good quality stock

There is a lack of good quality office stock across Southern Europe and as the unemployment rate continues to fall there is an increasing demand for good quality stock. Investors are behaving differently this cycle and are not willing to move into secondary or tertiary locations, and indeed tenants are demanding good quality office space in prime locations leading to competitive pricing. Opportunities are arising for investors to redevelop and renovate existing stock in the CBD for favourable returns. Development activity has been subdued since the GFC, however new supply is gradually rising through refurbishments in the CBD and the creation of new office hubs in city fringe locations.

Good fundamentals support investor demand

Lack of good quality space in the CBD has been putting upwards pressure on rents and increasing demand has caused a drop in office vacancy rates in Madrid, Milan and Lisbon.

Non-CBD rents are also rising, albeit at a slower pace than the CBD as they benefit from tight supply in the centre. Since 2016, Madrid and Barcelona have experienced the strongest European rental growth in Europe while Milan and Lisbon have recorded rental growth figures around the European average.

Retail rents are rising at a moderate pace, however tenants are beginning to consolidate their stores into one, large flagship store to promote their brand. The high street retail sector will be one of the biggest beneficiaries from the rise in consumer spending and tourism, particularly in Barcelona, Rome and other secondary cities with strong tourist flows. Investors have already started targeting these locations with retail investment in Italy rising by 70% last year.

Booming tourism sector

The tourism sector has continued to be a stable and booming industry with Barcelona, Milan, Rome and Madrid amongst the top ten European destinations per overnight international visitors. The Travel & Tourism sector accounts for 18.6% of GDP in Greece (forecast to rise to 23.8% by 2027) and tourist numbers are expected to grow at a rate of 4.8% per annum. Lisbon has been experiencing a strong take up in tourist numbers, especially

visitors from China, increased 19% in 2016, largely thanks to the Golden Visa scheme. Furthermore, Lisbon is one of the fastest growing European tourist destinations in terms of annual growth (+7.4% in 2016). Due to these positive trends, investors will increasingly target high street retail and hotels in these locations.

Hotel investment across Southern Europe reached €2.9bn last year - up from the €986m invested in 2015 - and this year the hotel investment is likely to be on par with 2016's volume.

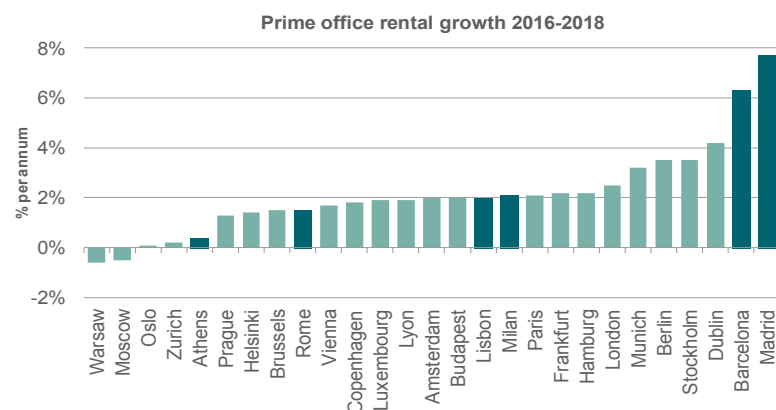
With Airbnb growing at a fast pace in Southern Europe, it will not be long before local governments will be under pressure to restrict the number of Airbnb lettings to mirror that of Barcelona, giving way for hotels to claw back overnight visitor numbers from Airbnb.

Tech sector & alternative ways of working

Although Southern Europe has been slow to embrace the online shopping boom, with the youth unemployment rate on a steady decline, a pickup in ecommerce is expected in the coming years as the Millennials and Generation X embrace the Tech boom. The growth of ecommerce will lead to increasing demand for logistics and warehouse space which has been lagging in Southern Europe.

The Tech sector has been enjoying strong growth across southern Europe and demand for serviced offices has been growing significantly. According →

GRAPH 3 Prime office rental growth Madrid and Barcelona expecting strongest growth



Source: Savills

“The available supply in the CBD continues to fall, despite the number of new and refurbished properties coming onto the market.”
Gema de la Fuente, Savills Research Spain

to Eurostat, Madrid, Lisbon, Barcelona and Milan are forecasting Tech GVA growth of 3.2%, 2.2%, 2.1% and 1.9% respectively over the next four years. The lack of good quality office stock has led to new ways of working and demand for flexi offices and co-working spaces. Indeed, one of the few positives to come out of the high unemployment following the GFC has been the increase in start-ups and entrepreneurialism, particularly in Portugal, which in turn will lead to more business creation and demand for office space.

compression in prime offices and retail become limited, we believe investors will divert their activity, not only to logistics but to alternative asset classes which will offer attractive yields. Already in Spain we have seen significant investor interest into the income producing residential sector, particularly student housing in cities with strong international student flows such as Madrid and Barcelona. ■

As the prospects for further yield

Prime yields Q3 2017*	Office	Six-month outlook	Shopping centre	Six-month outlook	Industrial & Logistics	Six-month outlook
 ES	3.25%	→	4.25%	→	n/a	n/a
 IT	3.50%	→	4.90%	→	6.00%	→
 PT	4.75%	→	5.00%	→	7.00%	→
 GR	7.50%	↘	7.25%	↘	9.50%	↘

Source: Savills* Madrid, Milan, Lisbon, Athens

OUTLOOK

The sunshine has returned to Southern European investment

- GDP is expected to grow an average of 1.95% per annum across the region and the unemployment rate is expected to fall to 12.4% by 2020.
- As the unemployment rate continues to fall, the need for business space will expand seeing the pick up of alternative work spaces and flexi working.
- Opportunities are arising for investors to redevelop and renovate existing stock in the CBD for favourable returns.
- The growth of ecommerce will lead to increasing demand for logistics and warehouse space which has been lagging in Southern Europe.
- Distressed assets are increasingly limited in Spain so pricing is not making sense to opportunistic buyers who are now looking elsewhere to Portugal and Greece.
- Southern European yields still have room to compress further. Yields in Spain and Italy will likely compress further in 2018 before stabilising towards the end of the year. Yields in Greece and Portugal will move in further throughout 2018 and early 2019 before stabilising in the second half 2019.
- As the traditional asset classes grow, investors will turn their focus to alternative asset classes where there is room for yield movement and more attractive pricing differentials.
- We expect the end-year investment volume to exceed €19bn; 42% above the long term average and we will likely see the 2018 investment volume surpass the 2007 historic peak.

Savills Southern Europe

Please contact us for further information



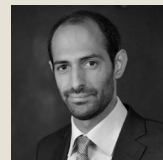
Alice Marwick
European Research
+44 (0) 20 7016 3833
amarwick@savills.com



Gema de la Fuente
Research Spain
+34 (91) 310 1016
gfuente@savills.es



Maddalena Panu
Research Italy
+39 02 632814214
maddalena.panu@savills.it



George Veinoglou
Research Greece
+30 (0) 210 6996311
g.veinoglou@savills.gr

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