

# *COVID-19: Implications for Italian Commercial Real Estate*

April 6, 2020

CBRE

# 1. IMPLICATIONS OF COVID-19 FOR THE ITALIAN ECONOMY

As COVID-19 continues to spread across Europe, its impact on economic growth is becoming increasingly evident. A global recession is now underway, with CBRE's House View expecting U.S. GDP growth to contract by -1.6% q-o-q in Q1 2020, followed by a decline of -5.4% q-o-q in Q2 2020. Western Europe is expected to see GDP shrink by -3% for 2020 as a whole, with a weak Q1 2020 and a severe downturn in Q2 2020.

In Italy, assuming that the outbreak will last until the end of May 2020, CBRE's House View forecasts a GDP contraction of -4.0% for 2020, which would start a new recession. However, as the scale and impact of the outbreak is changing on an almost daily basis, this forecast will need to be revised several times in the coming weeks as new assessments of the state of contagion in Italy and in the rest of the world are released.

Following its January 31, 2020 declaration of a State of Emergency, the Italian government moved quickly to contain the outbreak. On March 9, 2020, the government imposed a national quarantine restricting the movement of the population with exceptions for necessity, work, and health circumstances, and implemented lockdown restrictions mandating the temporary closure of non-essential shops. Recent additional lockdown restrictions have mandated the temporary closure of all non-essential production.

These measures are similar to those taken in China, raising hopes that the outbreak in Italy should follow a similar pattern and last around two to three months. According to the Bloomberg Health Efficiency Index and the World Health Organisation, the Italian healthcare system is considered one of the most efficient in the world, while the Italian National Civil Protection system has high standards of emergency management. The most pessimistic scenario of a healthcare system collapse is therefore considered highly unlikely.

On March 18, 2020, the Italian government enacted a €25 billion fiscal package named "Cura Italia" to support businesses and families during the COVID-19 outbreak. Measures include increased funding for the healthcare system; tax credits for firms that are facing revenue shortfalls; support for temporarily unemployed workers to preserve employment levels and incomes; and support for credit supply to families and firms (in particular micro-companies and SMEs). Additional fiscal packages are expected to be announced in the coming weeks.

Fiscal policy expansion will be supported by the European Commission's recent decision to trigger a clause relaxing European budget rules (see Box 1 overleaf). Together with the Pandemic Emergency Purchase Programme (PEPP) recently announced by the European Central Bank (ECB), greater flexibility in the Italian government's budget will enable the activation of public resources equivalent to between 8-10% of GDP.

This is intended to counteract the recessive impact of COVID-19 from H2 2020, leading to a likely scenario of negative growth in H1 2020 followed by a "V-shaped" recovery, assuming the outbreak is brought under control within a reasonable timeframe. CBRE's House View expects GDP growth to rebound to +3.7% in 2021.

Box 2 (see overleaf) analyses the impact of the COVID-19 outbreak on prices. CBRE's House View is that the impact will be deflationary in the short term (-0.1% annual CPI inflation expected in 2020) and then inflationary during the recovery (+0.5% annual CPI inflation expected in 2021), which would bring inflation back to around current levels.

Downside risks still weigh on this scenario. A prolonged outbreak is the main concern, with a second wave of COVID-19 in Asia – perhaps imported from other regions – likely to result in another quarter of lockdown. This would both prolong the peak impact, making 2020 worse, and would lead to a weaker recovery as companies and households would be in a worse position, making the 2021 bounce-back weaker. This would lead to a "U-shaped" recovery, in which a wave of company defaults, and more specifically, loan defaults that undermine confidence in the financial system, could pose a further threat to the economy.

A large part of the additional Italian public deficit will be purchased almost entirely by the ECB. This will counteract the downward push of ten-year government bond (BTP) prices and the rise of sovereign debt rates. However, an increase in Italian sovereign risk is unavoidable and already visible, although the "Italexit" risk has completely diminished. Italian long-term interest rates will be boosted, but the increase should be likely countered by the ECB Quantitative Easing interventions and also by further policy rate cuts. At present, it is reasonable to expect that the BTP-Bund Spread will remain below 250 bps in the scenario of temporary and limited negative growth (no more than two quarters) counteracted by announced fiscal and monetary polices.
Bond and equity financing channels are set to shrink due to the financial downturn already underway, while volatility is expected to pick up.

While the Italian banking sector experienced tightening credit conditions in late 2018, these saw progressive improvement in 2019. At the moment, a credit crunch triggered by growth contraction is unlikely given the announced massive injection of liquidity by the ECB and the government's fiscal package.

## BOX 1 – AN IMPORTANT REGIME CHANGE IN EUROPE

*Three relevant aspects characterise the current European Union policy framework:*

*a. A clause to relax the European budget rules has been triggered.*
*b. A new Pandemic Emergency Purchase Programme (PEPP) with an envelope of €750 billion (7,3% of EU GDP) until the end of the year has commenced.*
*c. The PEPP purchases will be conducted in a flexible manner: this allows for variations in the distribution of purchases among countries, over time and across asset classes.*

*Point a. implies that during 2020, Italy will widen its budget deficit beyond past constraints. Point b. implies that the additional deficit will be in large part financed by purchases of the ECB. Point c. implies that the size of this financial flow may be higher than the share normally reserved for Italy, based on its economic weight. Since ECB intervention may amount to 7.3% of euro area GDP, this implies that the support of the public budget to Italian GDP growth could be as high as around 8-10% (annual). Starting in Q3 2020 or Q4 2020, this monetary policy action should counteract the contraction of GDP caused by the spread of COVID-19. Given the high sensitivity of the Commercial Real Esate (CRE) sector to liquidity and credit conditions and the simultaneous international fiscal expansion, it is reasonable to expect Italian commercial real estate to remain resilient in the medium- to long-term.*

## BOX 2 – COVID-19 AND THE IMPACT ON THE PRICE LEVEL

*COVID-19 will affect pricing in opposite directions through supply side and demand side channels. On the supply side, costs per unit of production rise when productivity lowers, pushing prices up. In addition, bottlenecks that may occour in production can lead to a temporary shortage of certain goods, pushing prices up. Temporary closures of factories and the partial disruption of the supply chain could activate these inflationary channels. The upward pressure can be mitigated (but hardly eliminated) by the contraction in oil prices. On the other hand, demand is being weakened by the restrictive measures such as those affecting the tourism and transport sectors, and is also being constrained by the loss of income and financial wealth, such as through stock market losses, suffered by households, which will push prices down.*

*At present, the net effect of the two contrasting forces is difficult to predict, but a stagflation outcome (recession plus rising prices) is unlikely. Once the COVID-19 outbreak passes and repressed demand for goods and services rebounds, support from fiscal and monetary policies will likely lead to an inflationary recovery.*

## 2. IMPLICATIONS FOR ITALIAN COMMERCIAL REAL ESTATE

The Italian commercial real estate market entered 2020 in a strong position. Occupier demand in most sectors was robust and there was a considerable volume of capital targeting investment and development opportunities across all sectors.

There was a strong carryover of transactions from late 2019, with several letting and investment transactions expected to close in early 2020.

New supply was being developed and welcomed as a solution to the lack of product that has historically been a strong constraint to investment in the Italian market.

From an economic perspective, the COVID-19 outbreak is affecting the following three aspects of business in most sectors of the economy:

- the flow of revenue, which is falling significantly;
- the weight of fixed costs on total costs (operating leverage);
- the weight of short term debt (financial leverage), which is rapidly increasing.

The COVID-19 outbreak is already impacting many sectors of the economy - most notably aviation, hospitality, tourism and the retail sector.

The extent to which Italian commercial real estate fundamentals will be affected will depend on how prolonged and severe the COVID-19 outbreak will be and, consequently, how severely the three metrics above will be impacted by the recession now underway, and what the consequences will be for sectoral real estate fundamentals.

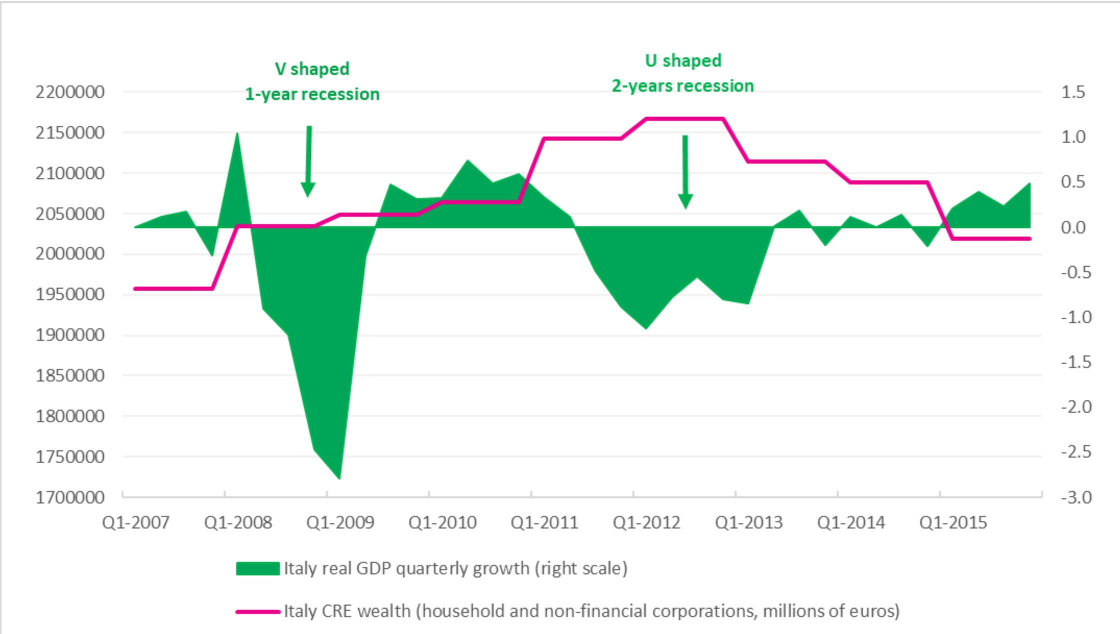
Investor and developer perception of risk could be impacted by a prolonged slowdown, which would prompt many groups to review their strategy. A structural reduction in development activity could mean the market returns to a shortage of investment product that it had been slowly overcoming in recent years.

## THE INVESTMENT MARKET

From an historical perspective, it is interesting to look at trends in private non- residential real estate wealth in Italy, in particular the aggregate value of commercial real estate assets owned by non-financial corporations and households.

This series (Figure 1) was highly resilient to the first V-Shaped one-year recession beginning in 2008, but suffered from the second U-shaped two-year recession beginning in 2011. The length of the economic slowdown resulting from the COVID-19 outbreak will therefore be crucial in determining the outcome for the Italian non-institutional commercial real estate sector as a whole.

Figure 1: CRE wealth of household and non-financial corporations and economic cycle



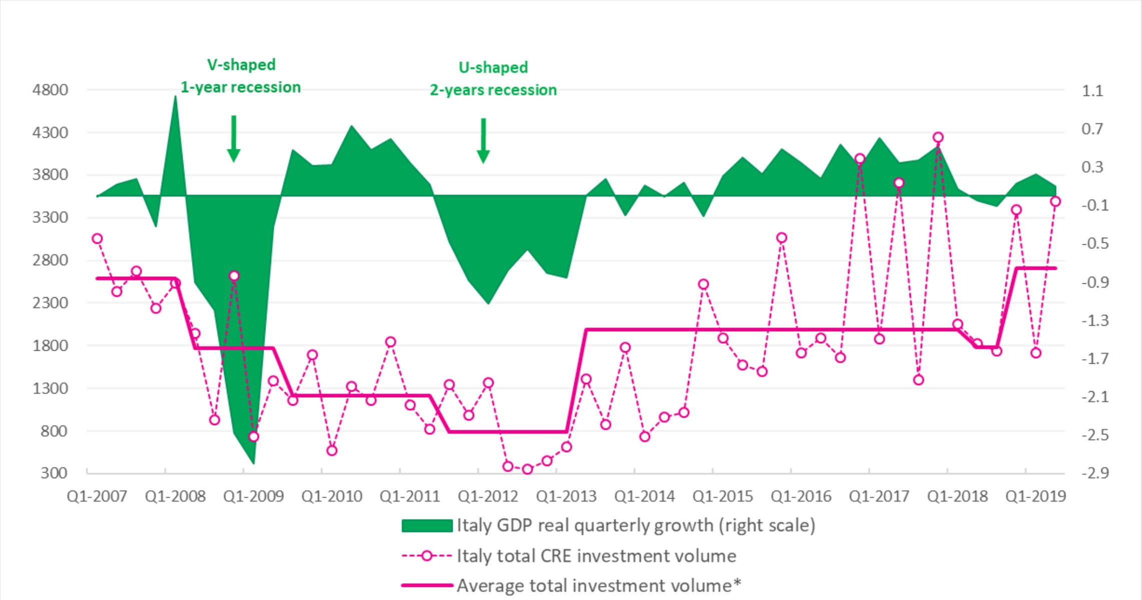

Source: ISTAT and Bank of Italy. Sample Q1 2007-Q4 2015.

Figure 2 (see overleaf) shows how Italian institutional commercial real estate transaction volume was strongly affected by the second U-Shaped two-year recession, which however represented the start of the new cycle that peaked in 2019 with over €12. 3 billion of investment.

Figure 1 and Figure 2 suggest that the effects of a recession on the Italian commercial real estate market vary depending on the length of the downturn. Commercial real estate capital values rely on sustained cashflow, therefore a contraction of a few quarters of such flow or a temporary increase in interest rates does not structurally change market conditions.

Figure 2: Italy investment volumes during the double recessions



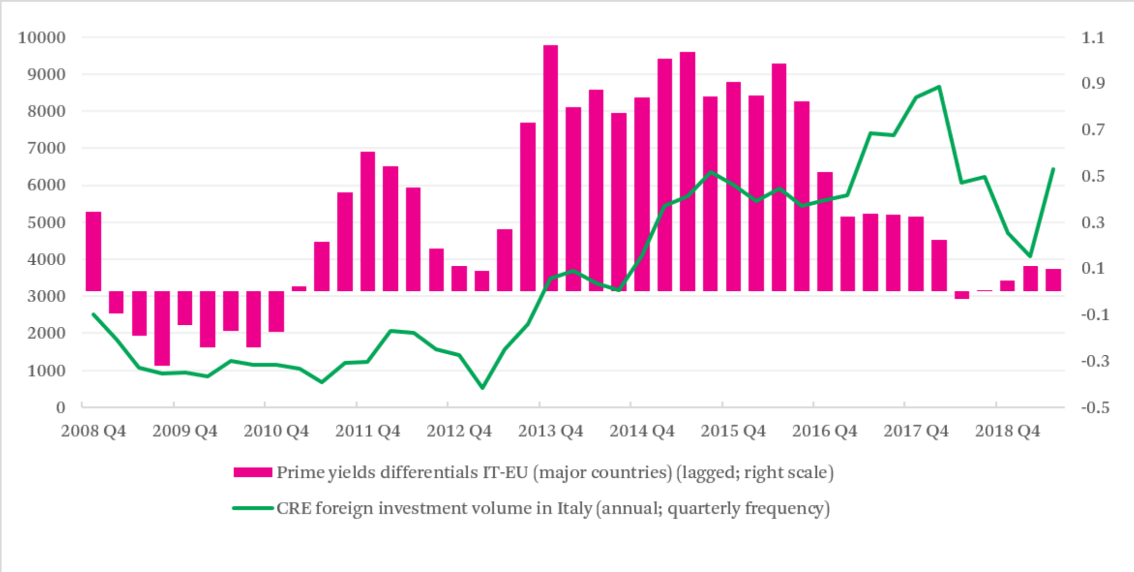

Source: ISTAT and CBRE. Sample: Q1 2007-Q2 2019
* average over the periods of negative or positive GDP growth.

The 2008-2012 recession was caused by a double negative demand shock originating in the financial markets. The European policy reaction to the shock was weak and delayed, while its financial system had many weaknesses at the time. The COVID-19 outbreak is more complex because it is affecting productivity and aggregate supply as well as demand. However, if the critical phase of the outbreak ends before the summer, the permanent effects of the crisis would be contained and a rebound, due to repressed demand and supply, would likely occur in 2021.

The European and Italian banking system is now stronger than in 2008 and the monetary and fiscal policy reaction has been massive and immediate (see Box 1). In addition, there is a qualitative change in policy intervention that foreshadows credit risk sharing between members of the European Union. This environment should support the commercial real estate sector in the immediate future.

Figure 3 (see overleaf) shows that commercial real estate investment increased after the 2012 sovereign debt crisis, driven by strong investment from overseas. This favourable trend has ben supported by the economic growth recovery since 2013, along with the rise in commercial real estate yield differentials between Italy and other EU countries, to some extent powered by high Italian long-term interest rates. The evolution of European real estate yield spreads over 2020 will be crucial to assessing the impact of COVID-19 on commercial real estate capital market dynamics.

Figure 3: foreign CRE investment volumes in Italy and IT-EU yield differentials




Source: CBRE Research. Sample: Q4 2008-Q2 2019
* The yield differentials are calculated as the difference between Italian yields (prime office Milan) and those of the main European countries (Denmark, France, Germany, Netherlands, Spain, Sweden and the United Kingdom) calculated by weighting the effective country yields (prime offices) of each country with the respective country share of the total investment. The series is lagged (six quarters).

The impact of the COVID-19 outbreak on the Italian real estate market is gradually becoming apparent. While Q1 2020 is likely to be a weaker quarter, the true impact will be visible during Q2 2020. Many transactions currently going through legal due diligence are likely to proceed and will eventually be completed. However, properties that are in or just before the marketing phase are seeing their sales campaigns and bid dates being delayed to facilitate the participation of global capital sources in face-to-face meetings and/or inspections later in the year when travel restrictions are lifted. CBRE has observed a more cautious approach from opportunistic investors interested in short- to medium-term capital gains.

CBRE expects a "flight to quality" scenario to emerge in the investment market, with core assets showing resilience. Hotel and Retail properties will be most negatively affected in the short- to medium-term, depending on the length of the COVID-19 outbreak and its impact on respective economic sectors.

Should the "V-shaped" recovery scenario occur, once activity restarts, CBRE expects a bounce in transactions and an active investment market, sustained by loose monetary and credit conditions and the controlled dynamics of the BTP-Bund Spread.

In many European countries, given the large discounts to NAV in the listed sector, equity investors are likely to explore opportunities in the public-to-private space. However, this may only be a side effect for Italy, which currently does not have a large listed real estate market.

As for the Italian NPL market, investors and lenders will need to adapt their recovery and business plans, quickly adjusting to the new environment in the coming months. In various cases, it is reasonable to expect that borrowers will ask for standstill periods ("moratoria"), although the new decree "Cura Italia" explicitly excludes companies with credit lines already classified as NPEs by the current banking regulation (including "past due", "unlikely to pay" and "defaulted loans"). A deterioration of the migration rate from *in bonis* (performing) situations to not-performing conditions is likely, if the economic slowdown persists, although the Italian banking system is more solid than in 2008 and 2011.

## IMPLICATIONS BY SECTOR

### HOTELS

After enjoying a banner year in 2019, with €3.3 billions of investment transactions closed, the outlook for the hotel market in 2020 was positive prior to the COVID-19 outbreak. However, since February, the hotel and leisure sectors have been severely impacted by travel restrictions and a sharp decline in domestic and international business and leisure travel.

The first impact came in the form of postponed and cancelled events. At the moment, the pace of future bookings is negative, meaning more cancellations than new bookings are being made for future dates. Cancelled stays and trips are being refunded, or vouchers to be used before the end of the year are being offered. Hotel occupancy in Italy has suffered the strongest decline across any market in Europe (STR data), probably due to the gradual pace in the spread of COVID-19 to other countries.

CBRE is currently assuming two possible scenarios for the hotel sector in Europe. The "Baseline" scenario assumes the outbreak is contained within five months in affected countries, with a full global recovery by year-end 2020. This scenario accounts for travel restrictions in markets where the virus is now widespread and reflects 72 million fewer visitors than in 2019. The "Downside" scenario assumes further containment measures are taken, resulting in a fall in global arrivals of 17.9% in 2020 (263 million fewer arrivals than in 2019). Under this downside scenario, effects would continue into 2021, and this would then be followed by a recovery. The big question mark at the moment concerns the length of travel restrictions and the impact on future travel behaviour. In Italy, CBRE expects that demand will likely be boosted by domestic tourism after the restrictions end, whereas international flows will recover more slowly, although this will depend on the global dynamics of the outbreak.

While CBRE is observing a slowdown in transaction and operator selection activity as a general "wait and see" approach takes hold, development and CAPEX projects with a time horizon longer than one year are flowing relatively steadily, suggesting confidence remains steady in the medium- to long-term outlook.

## RETAIL

The retail sector has been significantly impacted by the country-wide lockdown in place since the beginning of March. With the exception of supermarkets, drugstores and pharmacies, all retail and food and beverage shops across Italy must remain closed.

As a consequence, footfall and turnover in shopping centres has plummeted. CBRE's sample of managed shopping centres has recorded a significant number of renegotiation requests for rent reductions and rent delays.

From a retailer perspective, the major burdens at present are financing and labour costs. While rent reductions and delays will certainly assist, government measures (e.g. tax and contribution suspensions; credit and financing support; adoption of de-contribution and reduction of the fiscal impact during the period of closure and those immediately following, etc.) will be absolutely critical to supporting the sector in the coming months.

As shopping centre rents are usually linked to turnover, the "renegotiation wave" would represent a structural issue only under a scenario of prolonged recession that would permanently reduce consumption and structurally affect asset profitability.

In China, CBRE observed a quick recovery in footfall in the retail sector once the peak of the crisis had passed. CBRE estimates that 70% to 90% of stores were back in operation in China by mid-March. In Shanghai, 95% of shopping centres were in operation in mid-March, with footfall increasing by 30% on average from mid-Feb to mid-March. In the high street market, data show that China moved from an average store closure of about 65% in mid-February, to an average store closure of about 13% in mid-March across all sectors.

Since the Italian government announced its first restrictive measures, retail spending in grocery stores (online and offline), electronics (online) and pharmacies has increased, as the country's population has gone into self-isolation at home. However, after an initial spike, sales in these sectors has progressively normalised.

Urban supermarkets have registered the strongest growth, while regional shopping centres have suffering the most from competition from local supermarkets and restrictions on the movement of people.

CBRE believes the current situation will likely increase e-commerce penetration as shoppers progressively become accustomed to purchasing goods online, even though the recent spike in online sales is strictly linked to contingencies and primary needs.

The absence of physical stores is making click & collect services and returning online orders difficult, while the impossibility of visiting physical stores to "experience" goods is likely limiting online sales in some sectors. Ongoing difficulties in delivery (especially of groceries) are adding weight to CBRE's long-held view that retailers must integrate online and brick-and-mortar platforms into a unified omni-channel offering to ensure successful performance.

We believe that the current situation could represent an opportunity for retailers to adapt their format and strategies to better respond to the evolving needs of consumers once the outbreak is be over.

## OFFICE

Office take-up in Milan and Rome surged to a record high 480.000 sq. m. and 270,000 sq. m., respectively, in 2019.

While office-based jobs are likely to be less affected by the recession than those in the retail, leisure and hospitality sectors, there is huge variation in the ability and preparedness of companies to introduce widespread home-working. Parts of the financial sector face challenges with remote working due to regulation and data security. Although it is too early to anticipate a major decline in demand for office space, it is likely that office vacancy rates will rise according to the extent to which the downturn will impact the job market.

Some occupiers are adopting a "wait and see" stance in the short-term - a trend that is likely to constrain rental growth in the coming months, assuming landlords move quickly to support tenants through the downturn.

While CBRE has observed that office leasing deals in the final phase of closing are generally proceeding, initial work on new acquisitions, searches and projects have been delayed or shelved.

The COVID-19 outbreak could further weaken the Italian construction sector, which is already highly leveraged and suffering from stagnant growth. A recent study by CERVED ("L'impatto del COVID-19 sui settori e sul territorio", March 2020) assumes a turnover fall in the construction sector by about 8% in 2020 relative to the previous year in a "base" scenario (where the outbreak lasts until May 2020), and by 23% in a "pessimistic" scenario (where the outbreak lasts until December 2020). Supply chain and logistics issues arising from a disruption in manufacturing and transport could hamper the construction pipeline and affect renovation projects, if the outbreak is prolonged. This would affect the completion of several schemes – the pipeline of which is particularly strong in Milan – and potentially impact value-add opportunities in the long term.

## LOGISTICS

Activity in the logistics sector has surged in recent weeks due to the increased focus on ensuring supply chain continuity. This has led to an increase in precautionary inventory held by firms amid rising spending on food and consumables by consumers forced to stay at home. In some sectors, inventory has also been boosted by the recent increase in the volume of unsold goods.

Although some occupiers may delay major decisions until later in the year, CBRE has not observed any change in demand for logistics space from food, consumer goods, general retailers and healthcare segments. On the positive side, there has been spike in requirements for short-term space and cold-storage.

The surge in online retail activity will positively affect the logistics market in the medium- to long-term as e-commerce emerges as a structural driver of demand. The recent study by CERVED cited earlier forecasts a turnover increase for e-commerce firms of about 26% in 2020 relative to the previous year in the “base” scenario, and by 55% in the “pessimistic” scenario.

While the current inability to visit physical stores to “experience” goods is expected to limit short-term online retail growth - especially in the clothing, textile and fashion sectors – the COVID-19 outbreak is likely to drive a shift in consumption habits and lead to higher e-commerce penetration in the long-term. When consumer spending recovers, this could lead to an acceleration in the use of online channels for shopping – a scenario that would have clear real estate implications for logistics operators.

In the medium term, the disruption of supply chains and the economic downturn now underway will start to impact demand for logistics space if production decisions are permanently revised downwards by firms. When demand is structurally low, the optimal level of inventory shrinks (for a given storage capacity and cost), which would then affect rental growth.

While a prolonged cessation of activity in the construction sector might induce developers to adopt a “wait and see” approach for new Build-to-Suit (BTS) launches, CBRE has not yet detected any such sentiment. However, should the slowdown persist, speculative developments will suffer more due to increased pressure on financial resources.

CBRE believes that this period could represent a window of opportunity for major logistics occupiers to redefine their presence in the market by adopting cash generating strategies such as sale and leasebacks or by investing in e-commerce and urban delivery components that are displaying weakness during the outbreak.

## 3. CONCLUSION

While forecasting the economic impact of COVID-19 is challenging as the situation continues to evolve on a daily basis, the outbreak will have far-reaching consequences for the Italian commercial real estate market. Although some sectors will be relatively more affected than others, CBRE anticipates a "flight to quality" trend across all major property classes.

The European Central Bank's (ECB) approach to monetary policy suggests the low interest rate environment that has supported real estate investment over recent years is likely to continue for longer, with additional liquidity injections and fiscal space set to support the commercial real estate market.

Provided the outbreak is brought under control within a reasonable timeframe, leasing and investment activity will gradually rebound over the course of H2 2020.

## CONTACTS

**Giulia Ghiani**
*Head of Research | CBRE Italy*
T.: +39 02 997 462 63
giulia.ghiani@cbre.com

## CBRE RESEARCH

*This report was prepared by CBRE's Italy Research Team, which forms part of CBRE Research, a network of pre-eminent researchers who collaborate to provide real estate market research and econometric forecasting to real estate investors and occupiers around the globe.*


CBRE