Research Blast

European Real Estate Market, June 2016 Update

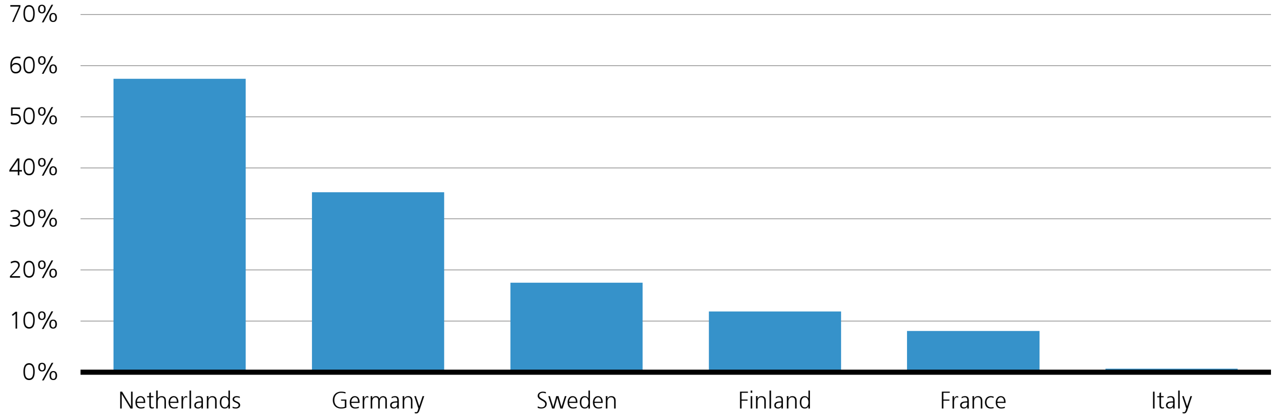
Italian investors are an emerging force of capital for European real estate

Due to the low interest rate environment and the increasing volatility of financial markets, appetite for real estate and its capacity to deliver stable income flows is growing fast. In most markets, the usual practice has been to first invest in the domestic market and then consider cross-border opportunities. This does not imply that real estate investment has been exclusively domestic, but there has been a strong home bias for the majority of investors. Real estate markets can be quite different across the globe and subject to different risks and local practices. With investor expertise typically focused on domestic markets, this has created a deterrent to those wishing to invest in non-domestic markets (beyond simply currency risk and tax issues).

Data regarding investors' geographical allocation of real estate investments is not easy to find, however a report published in 2012 by INREV (Investor Universe Comparison Study, November 2012) confirmed this preference for domestic real estate investments for most European investors. The data provided by INREV showed that Dutch investors were the only ones with a prevailing non-domestic allocation in real estate, partly due to the relatively limited size of domestic market. German investors followed with about one third of their real estate allocation outside of the home market. The remaining investors all showed a limited non-domestic allocation (below 20%), with **Italian investors representing an extreme case with an almost null international real estate allocation**.

Some of the largest Italian investors are starting to invest in international real estate markets and this could be just the beginning

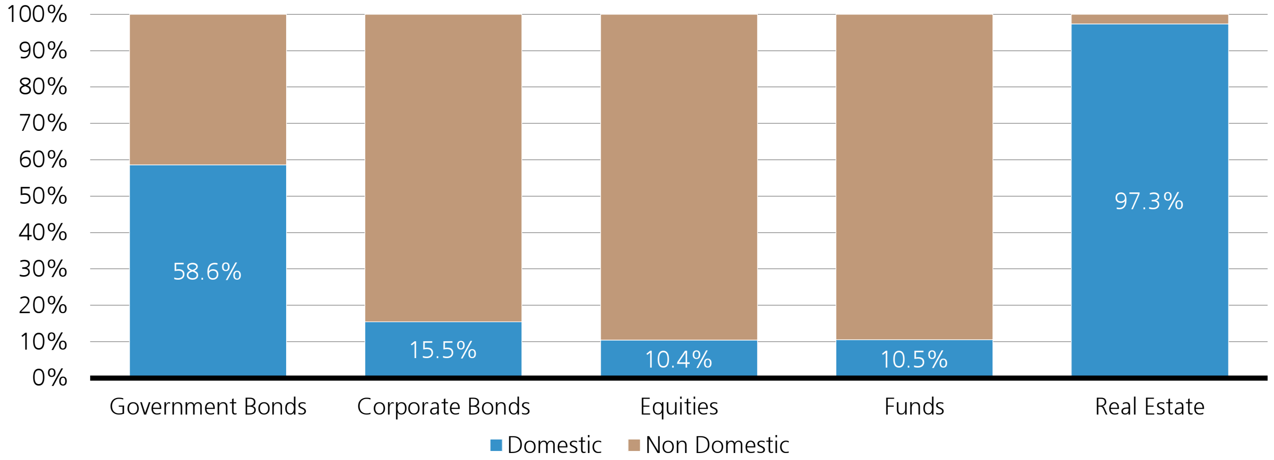
Non domestic real estate allocation by investor origin



Source: INREV "Investor Universe Comparison Study" November 2012, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

A more recent report (Investimenti al 31 dicembre 2014 Quadro di sintesi, March 2016) published by Covip, the Italian authority monitoring local pension funds, has given a precise and detailed description of Italian private pension funds' geographical allocation across all asset classes, including real estate. Unsurprisingly, asset classes such as bonds (particularly corporate) and equities show a largely diversified allocation within Italian pension funds' investments. On the other hand, the Covip report clearly confirmed the dominant allocation to the domestic real estate market. This report does not cover the other giant within the institutional playground, the insurance sector, but it is highly likely that similar results would be found for Italian insurers.

Italian pension funds geographic allocation by asset class



Source: Covip "Investimenti al 31 dicembre 2014 Quadro di sintesi" March 2016, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

To fully understand the reason of such an extreme situation within Italian pension funds' real estate investment allocation, a backward looking glance is useful.

The largest and oldest private pension schemes are the Casse di Previdenza which are the first pillar pension funds for professionals (e.g. doctors, lawyers, architects, etc.) and were established in the 1960s and, afterwards, privatized in 1995. Prior to their privatization, they were forced to invest in the residential sector for social purposes. Post privatization, they built up commercial real estate portfolios (mainly offices), usually with a wide diversification all around the country. In the last decade they started to invest through Italian Real Estate Alternative Investment Funds (RE AIFs) by contributing existing portfolios (generally with the aim of gradually disposing them) and by investing new equity flows (particularly setting up RE AIFs dedicated to a single Cassa). This change is now close to being finalized within all the main Casse and represents a revolution from an organizational point of view, as they switch from the internal day to day management of the owned properties to external management entrusted to asset managers specialized in the real estate segment. Today Casse still have, on average, a high exposure to real estate, which accounts for circa 27% of total assets under management. Such exposure is however expected to decline as a result of increasing total assets under management and of the expected disposals of a part of the existing Italian portfolio (particularly regarding residential assets).

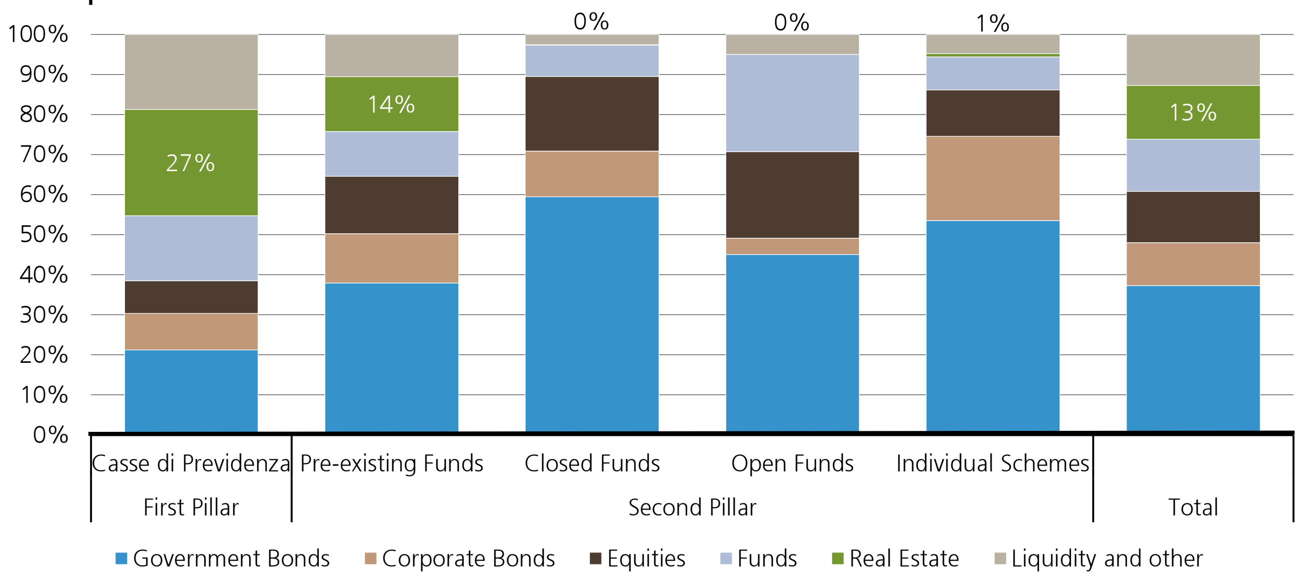
Within the second pillar schemes, Pre-Existing Funds, dedicated to corporate personnel (eg. Unicredit, BNL / BNP Paribas) or to specific categories of workers (eg. corporate executives), also have a long history, but they developed mostly since the early 1990s. Pre-Existing Funds are following, on a smaller scale, the same route as the Casse with regard to real estate investments. The average exposure of Pre-Existing Funds to real estate is also relatively high (14% of total assets under management); however, this varies significantly on a fund to fund basis, with some of the largest having no exposure to real estate.

The remaining second pillar schemes (Open and Closed Funds, as well as Individual Pension Schemes) are younger and they did not invest so far in real estate (with a few exceptions). Closed Funds are the largest second pillar scheme and are dedicated to specific categories of workers (sectors of activity, geographic location or a group of companies). They were generally established in the late 1990s after agreements among unions and corporates associations. The Italian regulatory framework limits Closed Funds to invest no more than 20% of total assets under management in real estate and only through commingled RE AIFs (with a maximum interest of 25% in a single fund). This regulatory provision, together with the lack of experience in real estate investments compared to other more mature Italian pension schemes, drive them to large RE AIFs with a multitude of investors. Such requirements do not match well with the characteristics of the Italian RE AIF market and Closed Funds may start looking to foreign domiciled RE AIFs, which are now easily marketable in

Italy thanks to the AIFM Directive. Non-domestic RE AIFs could also offer other interesting features from the point of view of Closed Funds, such as open ended structures which are not available under Italian regulations (the recent Ministerial Decree n° 166 of 2 September 2014 refers only to AIFs, independently from their open or closed ended nature) or more frequent NAV calculation, and could be acquired both directly or through dedicated real estate financial mandates.

Source: INREV, Covip, UBS Asset Management, Global Real Estate, Research & Strategy

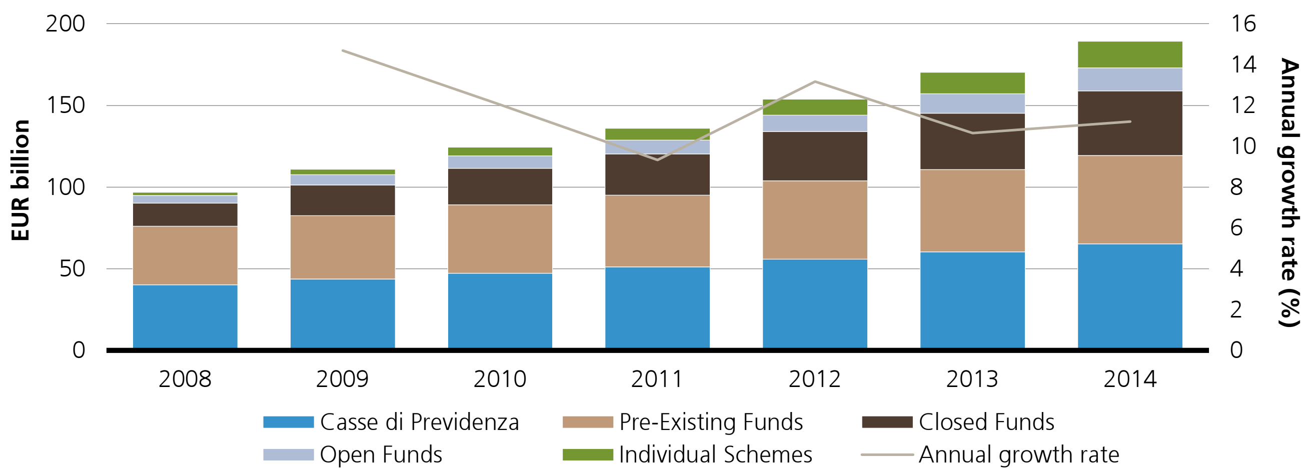
Italian pension funds asset allocation



Source: Covip "Investimenti al 31 dicembre 2014 Quadro di sintesi" March 2016 and "Relazione per l'anno 2014" June 2015, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

What all of these pension schemes have in common is that they are all growing fast. Even during the Global Financial Crisis, the growth rate of Italian pension schemes was safely above 10% per annum. Such growth is mostly due to the pension law reforms introduced during the last two decades which switched, in several steps, the Italian pension system from a defined-benefit structure to a defined-contribution structure.

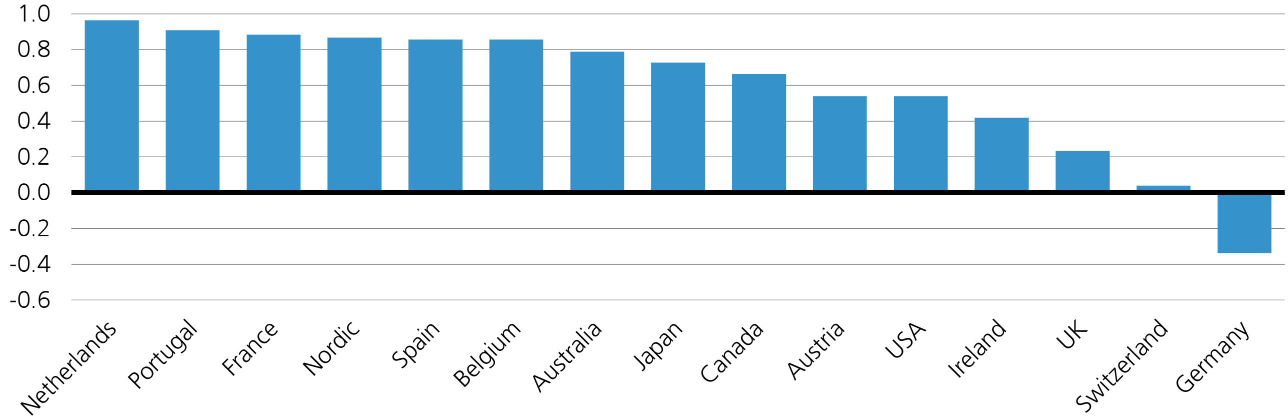
Italian pension funds asset under management by type of scheme



Source: Covip Relazioni annuali 2009 - 2015, Casse di Previdenza balance sheets, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

Moreover, it is worth noting that the allocation to non-domestic real estate investment in 2016 Covip report is higher than what was reported in the 2012 INREV report. Apart from some differences in the underlying sample of the examined investors, some Italian pension funds finally started to deploy capital into international real estate markets, with a particular focus on European markets. Indeed, as pension funds are now more used to relying on external asset manager, they are starting to leverage on their experience in international markets as well. Furthermore, the recent Italian real estate market downturn, which followed the Global Financial Crisis, was a sobering lesson which may have led investors to begin to appreciating the low correlation between the domestic market and some European real estate markets. In particular, the German market was inversely correlated to the Italian market during the last decade: while German real estate was considered a safe haven market during the economic crisis and was delivering consistent returns, the Italian market was facing significant hardships. Moreover, by investing in Eurozone countries, Italian pension funds have the opportunity to easily match their liabilities, but without incurring currency risk.

Correlation of real estate total returns with the Italian market



Source: MSCI, UBS Asset Management, Global Real Estate, Research & Strategy April 2016
Note: returns in local currency; the period considered is between 2005 and 2014

The current opportunity for Italian investors is therefore to reposition their exposure to real estate portfolios. First of all they could do so by investing new capital flows abroad and rebalancing their portfolios. But, maybe more interestingly, they could do so by disposing of part of their existing domestic assets by taking advantage of the large flows of international capital coming to Italy and subsequently reinvesting abroad, in order to achieve a higher level of stability within their real estate portfolios in the long term. However, this is not an easy process.

On the one hand, the capital targeting Italy with core and long term strategies (which are pushing real estate prime yields to unprecedented low levels in Italy) could be interested in prominent assets which Italian investors are unlikely to sell due to their high quality or the "flagship" status these assets hold within their portfolios. On the other hand, more opportunistic capital could be interested in secondary assets but only when significant discounts could be achieved. Finally, the reinvestment of disposal proceeds into foreign countries could be made difficult by political pressure to deploy available capitals domestically in order to support the recovering local economy.

However, in the current low interest rate environment, real estate could contribute to making asset and liability management strategies more sustainable for Italian institutional investors in the long term. Moreover, non-domestic real estate markets may facilitate this further by widening the investment opportunity set and by achieving a safer diversification. Recent behaviors of larger Italian institutional investors who are starting to invest significantly into European markets confirms this trend and they are likely to be followed by many others investors sooner or later.

This will result in a better alignment of Italian investors to those in other European countries in terms of real estate investment practice and in a sizable amount of capitals directed towards international real estate markets.

When combined with Italian insurance companies, EUR 5bn of equity could be a conservative estimate of the medium term capital flows from Italian investors into European markets. This will be driven by a mix of different factors, including: the increasing inflows to the pension funds industry and the rebalancing needs within the real estate allocation of more mature investors.

Source: INREV, Covip, UBS Asset Management, Global Real Estate, Research & Strategy

Real Estate Research & Strategy – Europe

Gunnar Herm
Nicola Franceschini

For more information please contact

UBS Asset Management
Global Real Estate Research
Nicola Franceschini
Tel. +39 06 4237 6573
nicola-za.franceschini@ubs.com

www.ubs.com/realestate

UBS