Research Blast

European Real Estate Market, June 2016

Changing cities: the evolution of Milan

One of the largest Italian cities in Italy, Milan is the leader in economic terms with the city's GDP accounting for circa 10% of total GDP, while Lombardy accounts for almost 25% of the total. Moreover in per capita terms, GDP and retail spending for Milan are on a par with the wealthiest, largest European cities. Milan is not only the economic fulcrum of Italy, but it has also undergone several changes recently to improve its infrastructure and draw in more tourists in the aftermath of the Global Financial Crisis (GFC), which had hit Italy harder than most of the other developed, European countries.

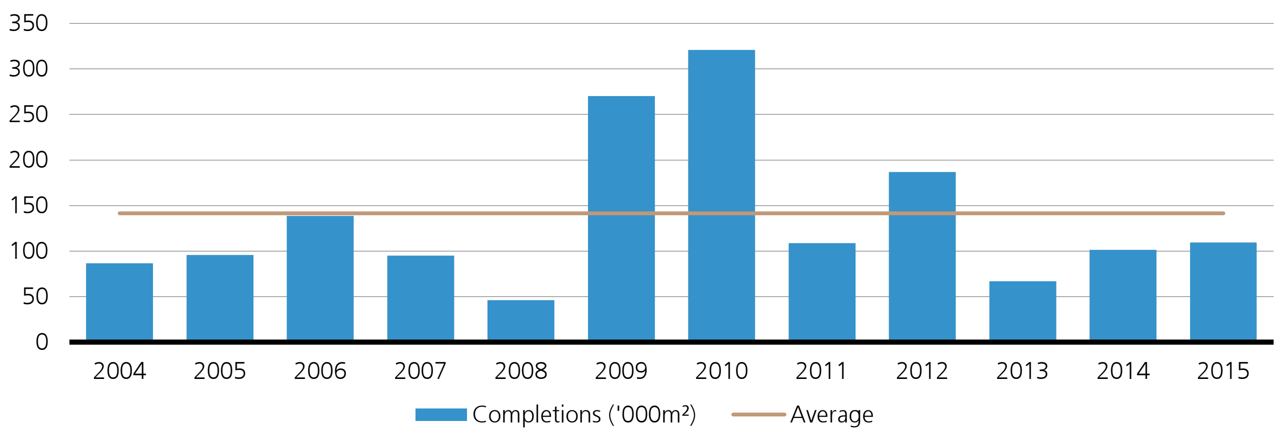
In 2015, Milan displayed its new credentials by hosting the Universal Exposition between May and October, attracting several million visitors in the process. Visitors found a city blending twenty-first century infrastructure with its long and rich heritage.

Milan has benefitted from an improved infrastructure. Since late 2009, the high speed train line linking Milan and Rome – as well as between the Universal Exposition and Malpensa airport – finally became fully operative and gradually became the main transport hub between the main Italian cities, connecting Turin to the north and Naples to the south. In 2013 the fourth Milan metro line was delivered, while several existing metro lines were extended. Milan's fifth metro line is currently under construction and is expected to be completed by 2022, connecting Linate airport with the city center. Finally, the regional road network has also been improved significantly. Milan is indeed a relatively small city with a population of circa 3.2 million, including those suburbs that are economically dependent on the city. Such infrastructure developments may appear relatively minor when compared to urban areas in other parts of the globe; however, the positive impact is substantial given the size of the city.

Recent real estate developments have also been taking place during that time, leading to substantial changes to Milan's landscape. Indeed, during the previous real estate cycle peak (2006–2008), several large areas of the city were the target of large real estate mixed-use development schemes.

Infrastructure and real estate developments are contributing to a rapid evolution of Milan's real estate investment market

Milan office market completions



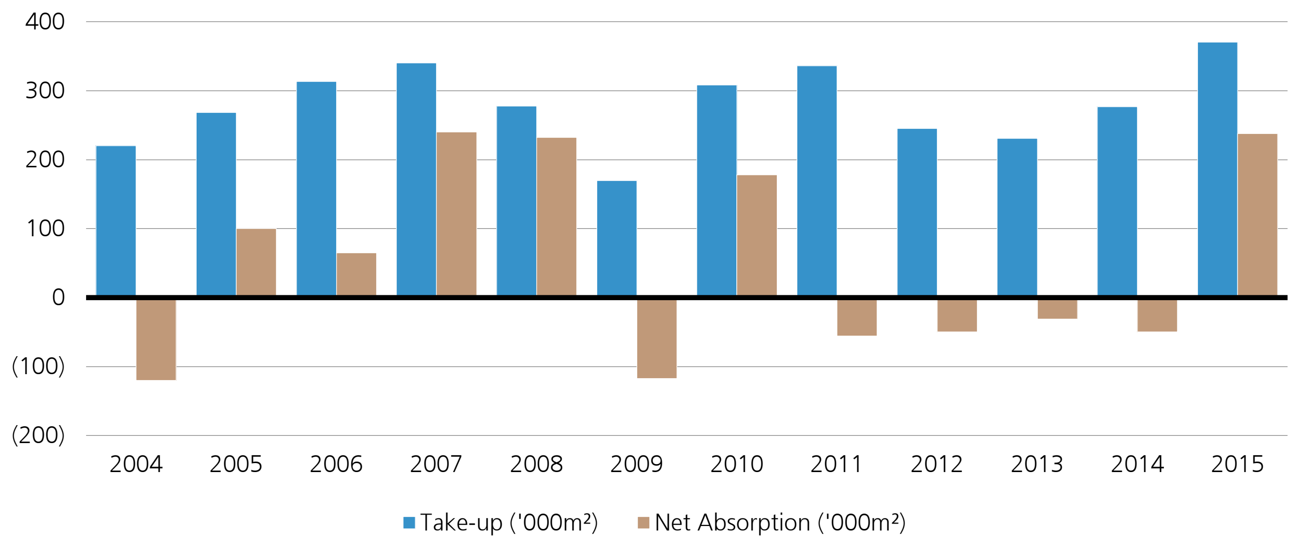
Source: CBRE, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

UBS

When the cycle became negative, not all of the developments were finalised. These included the former Falck industrial area in the northern district of Sesto San Giovanni and the Santa Giulia project in the south of the city. While these are unlikely to be developed in the short term given their size and location, other large projects in more central locations of the city have been completed since 2009, or are close to completion. Important examples of these are Porta Nuova development to the north of the city's historical quarter and the City Life project which is regenerating the site of the former Milan Exhibition Center, a short distance away from the historical quarter.

These projects and other, smaller developments, have a mainly office focus and came into the market in a period of weak fundamentals for office occupiers, when office based employment was decreasing and cost cutting strategies were very prominent. Indeed office net absorption between 2009 – 2014 was weak. Nevertheless, take-up levels in Milan during the economic crisis were relatively stable as a large percentage of the new office stock was absorbed, albeit at a slower pace than expected by developers. Energy efficiency, flexible space management and good public transportation connectivity were (and still are today) key requirements. Furthermore, tenants used to prestigious locations and historical buildings found a good alternative in landmark skyscrapers designed by renowned architects, which matched the new efficiency driven requirements and the high standing characteristics of the buildings.

Milan office market take up and net absorption



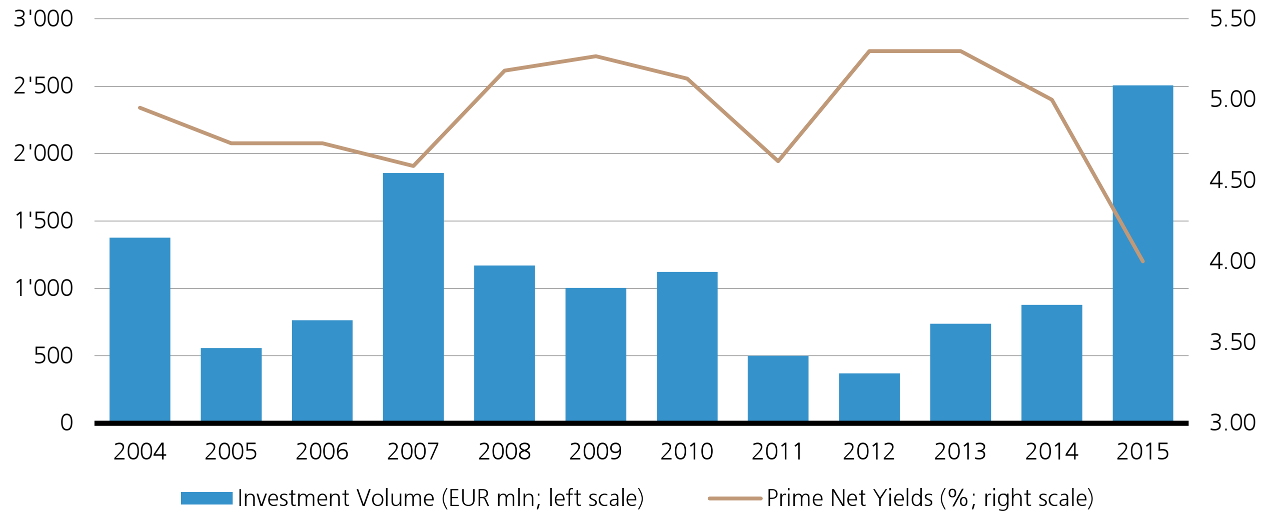
Source: CBRE, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

Such evolution of the city's infrastructure, together with the improving economic outlook, is creating investment opportunities for Milan real estate with different risk return profiles and sub-markets. In the historic centre of Milan, the recently vacated buildings are creating appealing opportunities for conversions to more suitable use within the micro context of the location (eg. high street retail, luxury hotel or residential) with a "manage to core" approach beginning with value-add or opportunistic strategies and ending with core, income producing assets. On the other hand, core and core plus office investments in the city center could also benefit from the above conversions, which will keep office vacancies at low levels and increase the exclusivity of the buildings in the most prestigious part of the city.

The area within to the two main train stations (Central Station and Garibaldi Station), which have seen the most important office developments and refurbishments in recent years, will continue to consolidate its office vocation. Recent developments have improved buildings previously seen as "average" and attracted tenants paying higher rents. This is having a knock-on effect by encouraging further refurbishments and re-developments. In this locality, core and value-add office investments are both on real estate investors' agenda, with most looking to take advantage of the anticipated growth in average rental values.

Subsequently, the investment volume in Milan reached its historical highest level in 2015 of ca. EUR 2.5 billion with prime yields falling below their pre-crisis level. It is also worth noting that this level of investments represented ca. 80% of the total volume (in 2015) of investment in Italian offices. Taking into account other property types (eg. retail, residential etc.), the actual investment volume in Milan exceeded EUR 4 billion, representing more than half of total real estate investments in Italy.

Milan office market investment volume and yields



Source: CBRE, UBS Asset Management, Global Real Estate, Research & Strategy April 2016

In the future, such investment strategies are expected to be confirmed; however, in the search for higher entry yields, investors will also target decentralized locations and offering a premium to prime yields. It is worth noting that investment in semi-central and peripheral business districts will need to be carefully analyzed from a microeconomic context. Indeed, the effects of the economic crisis are still visible, and in some business districts the vacancy rate (current and expected in the near future) is well above the city average. Therefore, in order to limit the risk of oversupply, the key drivers of investment decisions for decentralized offices in the Milan market appear to be matching the drivers of choice of office space occupiers; ie. flexible, modern, energy saving properties with good public transportation links. Finally, if economic fundamentals continue to improve, development activity may start to rise again in the medium term, and therefore the districts close to large areas potentially interested in future developments (eg. former railways areas and the area around Expo 2015) should be analyzed carefully.

Source: CBRE, 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