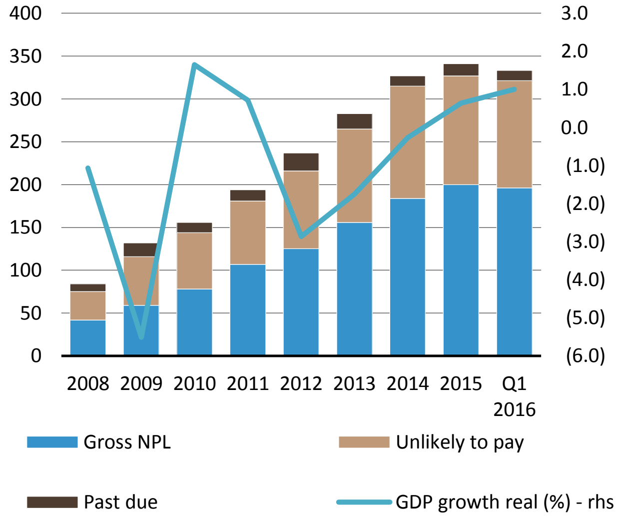
Research Blast

European Real Estate Market, July 2016

NPLs in the Italian banking system and potential impacts on commercial real estate

The Italian banking sector is currently seen one of the weakest in the eurozone, with the European Banking Authority reporting a Tier 1 ratio of 12% and a Return of Equity (RoE) of 3.3% in their 1Q16 Risk Dashboard. Since the beginning of Global Financial Crisis (GFC), Non-Performing-Loans (NPL) have risen in Italy, with solvencies of Italian banks attracting investors' attention with an NPL ratio of more than 16% (equivalent to more than EUR 320 billion in total), which is well above the European average of 5.7%. Should real estate investors be concerned of the current situation?

Italian NPL volumes and GDP growth

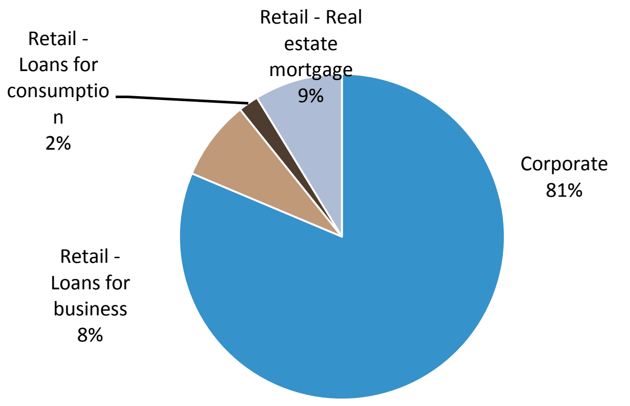


Source: PwC June 2016; Banca d'Italia (Bollettino Statistico 2Q16); Oxford Economics July 2016

Most of the NPLs are outside the institutional real estate market although sentiment is likely to suffer

The weak Italian banking sector is undoubtedly a threat to the economy and needs to be managed under European rules. Over the last few years, the protracted low economic growth environment has placed Italian corporates and households under pressure. This has led to an increasing volume of NPLs, mainly due to a sharp increase in financially distressed small and medium sized companies. Circa 9% of NPL volumes are in the retail residential sector while more than 80% are in the corporate sector. Real estate comes in to play because approximately half of corporate and retail NPLs are collatorized by real assets, and particularly real estate. On the face of it, this seems to be a concern but even if greater details of underlying asset characteristics are currently not available, most of the real estate is likely to be outside the institutional investment universe in manufacturing facilities of small and medium sized companies or residential developments in provincial cities. Therefore, direct contagion risk to institutional commercial real estate might be limited. However, we believe that sentiment towards the Italian real estate market may suffer, and the ability to secure financing might become even more restrictive.

Breakdown of Italian NPLs

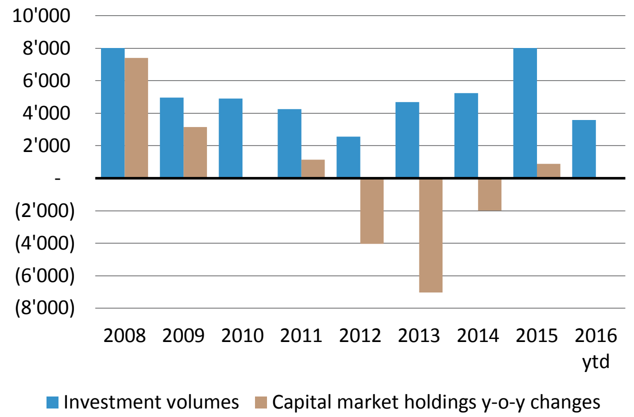


Source: Banca d'Italia (Bollettino Statistico 2Q16)

Deleveraging the commercial real estate sector

Limited availability of finance has been a major factor why the Italian real estate investment market has started attracting global investors later in this cycle. Italian banks have been restricting their lending books on commercial real estate over the last few years. The Italian lending sector is still in a deleveraging process, while capital market holdings in private and public debt have been contracting in recent years. Unlike other European markets, banks are still conservative in their lending policies, even for core assets. While in other European markets, loan-to-value (LTV) ratios of 60-70% for core assets are achievable, in Italy it is barely possible to get above 50%. Financing outside the core real estate segment is even more restrictive and is hardly existent. Domestic institutional investors, such as pension funds and insurance companies, are traditionally used to low LTVs (rarely above 30%), thus the deleveraging is not having significant impacts on their real estate investment strategies.

Commercial real estate investment volumes and changes in capital market holdings (EUR million)



Source: CBRE (investment volumes) 2Q16; Cushman (capital market holdings) 2016

As a consequence of the global financial crisis, development activity has been muted. Over the last two years in particular, occupier demand has improved slightly; however, a constrained supply situation in the core segment exists, leading to upward pressure on rents. Thus the investor is experiencing an improving environment in real estate market fundamentals. The low bond rate environment has also motivated institutional investors to search for investment alternatives and allocate more capital to real estate. Even though real estate prime yields (Milan prime office yields at 4% by end of 2Q16) have also come under downward pressure, the spread to Italian bond yields is significant (274 bps as of July 22, 2016).

Sound real estate market fundamentals in the core segment may create investment opportunities in a pausing market

Undeniably, serious issues in the Italian banking sector exist. A weaker economic environment will influence occupier demand negatively; however, supply and development activity in the core segment remain constrained. Thus, the rental growth outlook may weaken but not deteriorate as real estate market fundamentals are in balance. If the situation in the Italian banking sector was to worsen, the consequences are likely to be felt mostly outside the institutional real estate segment. Uncertainties may lead to a pausing of the Italian investment market and may even put some limited pressure on capital values in the core real estate segment. On a positive side, however, this may even create opportunities for equity-rich investors or alternative lenders.

Real Estate Research & Strategy
Gunnar Herm
Nicola Franceschini

For more information please contact:
UBS Asset Management
Global Real Estate Research & Strategy
Gunnar Herm
Tel. +49-69-1369-5317
gunnar.herm@ubs.com

www.ubs.com/realestate