Residential development in Italy
Challenges and opportunities in the market

Do you have the necessary tools to assess the “new normal” and surf the wave?
February 2018
The Italian Residential Real Estate market is characterized by specific attributes. Each of them should be properly addressed and investigated in order to identify reasonable trends for the industry and potential implications from an investment perspective.

Ownership: accordingly to data from Agenzia delle Entrate (Rapporto Immobili 2017, based on figures as at Dec 31 2014), 77.4% of Italian families live in a directly owned residential unit. In Italy the rental market in the residential sector is still small, even if there are some signs of recovery. While gross rental yields (return earned on the purchase price of a rental property, before taxation, vacancy costs, and other costs) are under pressure, the raising of rental market is the result of (i) demographic trends, (ii) economic challenges and (iii) lower home buying power.

Demographic factors: Considerable changes in the population composition represent a decisive factor that will shape future residential market demand; in particular key trends include increase of average population age, number of births' reduction, increase number of families, but with a reduced number of components, impact of immigration.

GDP correlation and macro economic environment: Italian Gross Domestic Product growth in 2017 was circa 1.6% the strongest growth recorded since 2010. Unemployment index is declining which indicates robust job creation. The economic outlook is positive.

Financing house purchases: Based on the latest Report from Agenzia delle Entrate (Gli Immobili residenziali in Italia – 2017), the proportion of house purchases financed with a mortgage grew to circa 48% in 2016 (average national data); major Italian banks are back in the lending market and this is providing a relative boost to the number of transaction.

Supply reduction: while many residential development halted during the financial crisis and then in particular between 2012 and 2015, the increased number of transactions observed in last three years and the consequent reduction of the available supply, are creating the conditions for a new investment phase. The new paradigm focuses on sustainability, flexibility and features that are aligned to the demand's criteria observed in the market.

In addition to the above mentioned features, the so called Digital Revolution has also started to impact also the real estate sector, primarily in the following aspects: (i) market intelligence and demand assessment, (ii) marketing and communication, (iii) design and project/construction management and (iv) agency services.

A new development pipeline appears necessary to keep the momentum and to feed the new demand, and many investors, including the opportunistic ones, are back in the development asset cluster. This new era of growth in this complex industry provides multiple opportunities but also poses specific challenges.

This is where EY can help investors and operators unearth hidden opportunities and overcoming the challenges.
Italy at a glance

An overview of the current state of the Italian economy

Based on the last projections by Banca d’Italia (1) Italian Gross Domestic Product is expected to growth by 1.6% in 2017, the strongest growth rate since 2010. Growth rate is expected to be 1.4 per cent in 2018, and 1.3 per cent in 2019.

These growth estimates are significantly favorable than the forecasting scenarios of the European Commission and the IMF, which have forecasted that GDP will witness a modest growth in the next two years. Compared with the previous macroeconomic projections from the Italian Central Bank, published in J uly’ edition of Economic Bulletin, the GDP growth is now higher (by 0.1 percentage points on average per year during 2017-2019). The revision mainly reflects more favorable conditions pertaining to domestic and foreign demand and interest rate. These encouraging developments are partially offset by the negative impact of higher commodity prices and the appreciation of the exchange rate.

Domestic demand is expected to be the main driver of economic activity; the contribution of net foreign demand, that is negative again this year, is expected to be negligible in 2018-19.

By 2019, the GDP is expected to have recovered from the decline as a result of the sovereign debt crisis that began in 2011. However, it is still expected to be around 3 per cent below the level of 2007.

The unemployment rate is expected to fall gradually, from 11.7 per cent in 2016 to 10.5 per cent in 2020. The fall in unemployment rate is partially offset by (i) increased labor market participation in response to the steady improvement in employment prospects and (ii) the increase in retirement age. The employment rate is projected to increase by around 4 percentage points from 2017 to 2020.

Investment, which began to expand at the end of 2014, is expected to continue to do so at a relatively fast pace. That in productive facilities will grow at an average annual rate of 3 per cent, thanks to strengthening demand prospects, still very favorable financial conditions, and tax incentives. It is estimated that these measures contributed significantly to the acceleration of investment in 2016, which was especially marked in the second half of the year.

Inflation, as measured by the harmonized index of consumer prices, rose to 1.3 per cent in 2017 (from -0.1 per cent in 2016), and is expected to fall to 0.9 per cent in 2018, then turn upwards again to 1.6 per cent in 2020.

(1) Banca d’Italia, Macroeconomic projections for the economy, 15 December 2017
Consumer Confidence in Italy averaged 103.70 between 1982 and 2017 (2), reaching an all time high of 120.86 in November 1988 and a record low of 82.40 in January 2013. Based on Istat estimates, consumer confidence in Italy increased to 116.6 in December 2017 from an upwardly revised 114.4 in November. All components improved: economic outlook (143.0 from 123.1 in July), personal (106.9 from 101.6), current (112.0 from 106.3) and future expectations (121.3 from 108.4). Also, the balance concerning unemployment declined (11.1 in Dec 2017).

EY analysis on Bank of Italy and Istat data

Italian GDP Real - (2017 forecast)

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<tr>
<td>GDP</td>
<td>1.45</td>
<td>1.5</td>
<td>1.55</td>
<td>1.6</td>
<td>1.65</td>
<td>1.7</td>
<td>1.75</td>
<td>1.8</td>
<td>1.85</td>
<td>1.9</td>
<td>1.95</td>
<td>2.0</td>
<td>2.05</td>
<td>2.1</td>
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<td>2015</td>
<td>2.15</td>
<td>2.2</td>
<td>2.25</td>
<td>2.3</td>
<td>2.35</td>
<td>2.4</td>
<td>2.45</td>
<td>2.5</td>
<td>2.55</td>
<td>2.6</td>
<td>2.65</td>
<td>2.7</td>
<td>2.75</td>
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Housing market

Residential units 2015: 5,269
Other asset 2015: 897

Households’ net asset value (Euro Billion)

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<tr>
<td>Res. units</td>
<td>2,200</td>
<td>2,684</td>
<td>4,136</td>
<td>5,269</td>
<td>4,952</td>
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<tr>
<td>Other asset</td>
<td>462</td>
<td>551</td>
<td>722</td>
<td>883</td>
<td>977</td>
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<tr>
<td>Total Tangible asset</td>
<td>2,662</td>
<td>3,235</td>
<td>4,858</td>
<td>6,152</td>
<td>5,849</td>
</tr>
<tr>
<td>Cash &amp; cash equivalent</td>
<td>685</td>
<td>675</td>
<td>888</td>
<td>1,009</td>
<td>1,211</td>
</tr>
<tr>
<td>Bonds (incl. Gov Bonds)</td>
<td>400</td>
<td>496</td>
<td>726</td>
<td>707</td>
<td>528</td>
</tr>
<tr>
<td>Other asset</td>
<td>701</td>
<td>1,829</td>
<td>2,203</td>
<td>1,87</td>
<td>2,158</td>
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<tr>
<td>Total Financial asset</td>
<td>1,784</td>
<td>3,002</td>
<td>3,817</td>
<td>3,590</td>
<td>3,897</td>
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<tr>
<td>Total asset</td>
<td>4,447</td>
<td>6,235</td>
<td>8,675</td>
<td>9,743</td>
<td>9,756</td>
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<tr>
<td>Res. mortgages</td>
<td>51</td>
<td>98</td>
<td>272</td>
<td>368</td>
<td>380</td>
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<tr>
<td>Other loans</td>
<td>121</td>
<td>177</td>
<td>212</td>
<td>323</td>
<td>303</td>
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<tr>
<td>Other liabilities</td>
<td>90</td>
<td>156</td>
<td>194</td>
<td>221</td>
<td>223</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>262</td>
<td>431</td>
<td>679</td>
<td>911</td>
<td>906</td>
</tr>
<tr>
<td>Net Asset Value</td>
<td>4,181</td>
<td>5,804</td>
<td>7,996</td>
<td>8,831</td>
<td>8,850</td>
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</table>

(2) ISTAT, Consumer and business confidence, press release, 22 Dec 2017
(3) Banca d’Italia, La ricchezza delle famiglie italiane, 2015
Since 2014, Italy has experienced gradual improvement in the labor market, with unemployment rate decreasing, return of modest inflation, GDP growth. And the residential market took advantage of the positive macroeconomic trends, even if in volume terms, rather than in prices.
Residential transactions

Back on track after the longest phase of decline ever recorded

The residential market, after a long and crippling crisis started in 2008, seems to be on the path for recovery.

In 2016 the number of residential units sold, as recorded by Agenzia delle Entrate reached around 530,000 units (+18.9% versus the previous year with).

Based on the first three quarters performance, we expect the total number of residential transaction in 2017 to be in the range 550,000 and 555,000, recording a growth of 5% compared to 2016. The estimate for 2017 reflects a considerable gap versus the top level ever recorded in Italy (year 2004, circa 900,000 transactions), but the 2017 recognized the third year in a row of continuous growth.

The 2017 figures are aligned to the long term average recorded in Italy since 1958, but is still far from a potential peak based on the linear trend line in the same historical period.

A focus on some of the most important cities shows different trends, compared to the national average.

Owing to its size, Rome has reaffirmed its relevance in terms of overall number of residential transactions. Furthermore, Rome seems to be a more resilient market, with a deals flow that has always overbeat the national average.

The performance in Milan was in line with the national average, between 2000 and 2012, but has been showing signs of relatively faster recovery since 2013.

Finally, while the transactions in Turin was aligned to the national average, Naples had the worst deal flow, with the number of residential transactions in 2017 still below the number recorded in 2000 and 50% less the peak of the market that was recorded in 2003.
Real Estate cycles in Italy
Any chance to predict future trends?

The phenomenon of cycles in the real estate market is the result of specific characteristics and features of the industry; among others, the relevant “time to market” (the large delay from the design of a real estate complex to the delivery in the market).

From 1958 we can identify 5 cycles in the residential real estate Italian market; the fifth one has started in 2014, when we recognized the inversion of tendencies in terms on number of transactions.

The average length of the cycles in the Italian market is circa 13 years. All the cycles have similar common features and trends, particularly with regard to the correlation between house price index and transactions trends.

The forth cycle (1996 – 2013) lasted for 17 years. One of the reasons behind such an unusual duration, may be identified in lower number of transactions in the third cycle, due to the overall political and economical uncertainty during the 90’s.

In such a cycle, additionally, it was characterized by a series of circumstances that can be considered, jointly, as unique: (i) introduction of Euro; (ii) long period of consistent GDP growth; (iii) low interest rates. As a result of such unique features, while the overall trend in terms of prices appears to be aligned to the historical data, the cycle was characterized by an unusual growth of transactions in the year 1996 – 2007, followed by a consistent reduction, with figures recorded in 2013 aligned to the performance recognized in the mid 70’s.
It’s generally accepted the a key factor that affects real estate values and properties’ demand is the overall health of economy. This is generally measured by indicators as the manufacturing activity, prices of goods, labor market, even if GDP is the most frequent parameter assumed as reference.

The reason for this relationship is relatively straight forward: over the time, GDP growth should lead to improving occupier’s demand and in turn higher rents and capital values, which drive property returns.

The historical comparison of residential transactions’ trend and GDP variation, shows in Italy a certain correlation. The GDP growth expected in the period 2018 – 2020, based on Banca d’Italia forecast, let the market being confident about the near future trend.

Another key parameter that can affect the residential transactions’ trend is represented by the number and volume of financing house purchases. Even if Italy has always been a market with a relevant percentage of houses purchased without a mortgage loan, the percentage was down to circa 37% in 2012 but in 2016 was back to circa the 50% And further to the increase in the number of financed deals, the market showed a significant increase in the overall amount of new loans.
While the comparison of the current situation with the historical cycles let us being confident about the future performance, some dramatic changes in the demographic composition of Italian households highlight some concerns.
Demographic changes and implications from a real estate market perspective

Some thoughts around characteristics and composition of households

Three main factors are shaping demographic trends, with relevant implication also from an economic perspective: (i) increasing population age; (ii) low birth rate; (iii) immigration.

Such phenomena are driving the mutation in composition of households, with a sustained growth and decrease in the household size.

A long term comparison of households’ number and residential transactions trends (net of the yearly fluctuations) shows a correlation in the period 1961 – 2001. However, starting 2002, the accelerated increase in the total number of households in Italy has not contributed to the growth in the residential transaction market. In particular, despite the accelerated growth of the total number of households recorded starting from 2002/2003, the residential transaction market has strongly dropped and for the first time ever, such decline led to levels below the long term trend represented by households variation.

Further analysis around the composition of Italian households suggest a way of reading of such phenomenon. During the 60s and 70s the growth of families was driven by the increase of households with two or more components. It easy to assess that a growth with such characteristics can have a direct and immediate implication in terms of demand for residential units and lead to a relatively sustainable supply growth. However, starting from the 90’s, the incremental growth of families with two or more components started to drop down. In particular, in the last five years we have observed a reduction of such a cluster, with the relevant growth of the so called singles. Furthermore, in many areas in Italy, the growth of the total number of households was driven by immigration.

We expect that such trends will continue in the future, and main implication from a real estate market perspective can be drafted. First of all, without a real growth of families with two or more components, the traditional residential demand will probably fall down. Such reduction will impact the sustainability of a positive change in stock and, actually, the increase of the vacancy rate is already clear in the market (as already occurred starting from 2001, with a more evident trend from 2012, in conjunction with the observed reduction of the number of “traditional” families).

On the other hand, it appear also clear that the market is still not able to supply the potential demand with products aligned to the wider demand coming from increasing clusters: (i) senior people; (ii) young single; (iii) immigrants.

In this scenario, what is also at risk is a key component of the household net asset value: their house. That is because the residential stock “as is”, in the future may not being aligned to the market requirements (i.e. in terms of size, type of tenure, flexibility), with a potential reduction of capital values. Only prime locations would probably guarantee a safeguard. Recent estimates from Istat confirm the trend; in the third quarter of 2017, prices of new dwellings increased by 0.3% compared to the previous quarter and by 0.6% with respect to the third quarter of 2016 (up from +0.3% observed in the second quarter); prices of existing dwellings decreased by 0.7% compared to the previous quarter and by 1.3% with respect to the same quarter of the previous year.

EY analysis on Agenzia delle Entrate and ISTAT data
Changes in the composition of Italian families are linked to other two demographic trends: (i) aging of the population and (ii) immigration.

Italy is one of the countries in Europe (and world wide) with the higher average age and the higher share of people in the age in excess of 65 years. Reasons behind such situations are usually related to the Italian average life expectation (one of the highest worldwide) and to the low birth rate.

Taking into account the variability associated with demographic events, the population estimates by 2065 from ISTAT ranges from a minimum of 46.1 million to a maximum of 61.5 million. The chance of a population increase scenario by 2065 is 7%. According to the ISTAT population forecasts, the resident population expected for Italy is estimated to be equal to 58.6 million in 2045 and 53.7 million in 2065. The decrease compared to 2016 (60.7 million) would be 2.1 million of residents in 2045 and 7 million in 2065.

International migration is expected to change level and composition of the future population. In the period 2000 – 2016, the Italian population was stable thanks to the immigration and in the future the trend will be more and more evident. But, starting from 2011, it has been observed a certain reduction in the immigration inflow, due to (i) financial turmoil and (ii) political and economic uncertainty.

In any case, while the net migration is expected to be positive, being on average more than 150,000 units annually (133,000 last observed in 2015), although characterised by a strong uncertainty, it probably will contribute to the demographic stability only in major cities, industrial districts and, generally speaking, in locations with a dynamic labor market.

Furthermore, based on the last available data (2015), only 25% of households there at least one member is foreign are buying their house, compared to a national average close to 80%.

As a result of this phenomenon, it will therefore be reasonable to create territorial imbalances, with prime cities, especially in the Northern Italy, that will strengthen their position and will more and more attract talents and young people. The implication from a residential market perspective could be relevant, with a raising housing demand from households that will consider to rent rather than to buy.

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(4) ISTAT, The demographic future of the country, April 26 2017
Some further thoughts about Milan

In last decade Milan has strengthened its position as a major economic and financial hub in the country and as one of the more dynamic and innovative metropolitan area in Europe.

However, population growth was stable, with an overall increase of circa 37,000 people (2005 – 2015), meaning a + 2.8%.

Also in Milan, there was a change in demographic shape of the city. While Italian population declined in the same period by circa 55,000 units (-4.8%), the number of foreign citizens increased by circa 5.7% (+92,000 units).

The variation in the composition of households reflects also such changes. The total number of households increased by circa 47,000 units (+7.50%), households with 2 ore more components felt down of circa 0.90% meaning a reduction of circa 3,300 units. To be recognized the strong increase of singles (+50,000 units), in particular in the age between 35 and 64 years.

Implications in the residential market are evident. In 2016 circa the 90% of the total residential transactions comprised small or medium size apartments (less than 3 rooms), compared to a national average of circa 65%. In addition, in the city there is a still important stock of large apartments with more than 4 rooms (circa 20% of the entire stock), but the demand trend let us being skeptical about the market appeal of such type of product in the future, with main implications about capital values.

Young singles, immigrants, seniors, seems to be also in Milan the market drivers also in the residential market and the existing and future supply should be able to address requirements of such customers.

EY analysis on Agenzia delle Entrate and ISTAT data
Between 1982 and late 90’s, residential transactions and new available supply trend were aligned. Then, the accelerated transaction growth, more clear starting from 1996, had as a result the increase of the development activity. But, as often occur in the real estate sector, due to the relevant time to market, the new product arrived late in the market. Furthermore, due to the financial turmoil, the scarce availability of financing and the overall market uncertainty, the number of new product dropped to the circa 41,000 units, the lowest level ever recorded in Italy since the end of the World War II.

Based on our analysis, between 2000 and 2009, the unsold units can be estimated in circa 400,000 units; from 2010, the increased number of transactions lead to a moderate take up of the unsold units; it’s our view that currently the unsold units stock has been reduced to circa 100,000 units, and, in some locations, the demand is overbeating the supply, with signs of prices growth.
According to preliminary estimates from ISTAT, the third quarter of 2017 witnessed a slight decline in the House Price Index (national average). Such a decline is driven by the further price reduction for existing dwellings, while new product shows a different trend, with a 0.3% increase compared to the previous quarter and by 0.6% with respect to the third quarter of 2016 (up from +0.3% observed in the second quarter).

After a strong reduction observed between Q4 2011 and Q1 2015, house prices in Italy remain more or less stable, even if the slight decline observed in 2017 is actually something unexpected.

The observation of prices evolution in some of the Italian major cities highlights different tendencies.

Milan has maintained a certain stability in the period 2007 - 2016.

Rome highlighted signs of recovery in 2011 and 2012, but in 2015 and 2016 a price reduction was clear.

Turin continued to growth until 2012, but witnessed an erosion in price post 2012.

Naples showed a continuous and significant price decline.

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(5) ISTAT, House Price Index - IPAB
(6) EY analysis based on OMI - Agenzia delle Entrate, Osservatori Territoriali
Many evidences in the market allow us to being confident about the sustainability of a new investment phase in the residential real estate market. But market and society has experienced dramatic changes in last 7 years. Do you have the necessary tools to assess the “new normal” and surf the wave?
Many evidences in the market allow us to being confident about the sustainability of a new investment phase in the residential real estate market.

However, it is evident that the customer base has changed. And it is going to change further in the near future.

A successful investment journey in the residential development in Italy needs the capacity to give answers to specific questions. In example, some of such questions may be as follow.

- Is it clear to me who is my customer base?
- Does the potential customers in the catchment area of my development project is more interested in buying rather than in renting residential properties?
- How can I better understand main product features, to be sure to match market and customers expectations?
- In which part of the real estate cycle do we stand now and where we expect to be when the product is finalized and delivered to the market?
- If the customers are more interested in ranting, which kind of financing structure may be efficient to protect my returns?
- Am I able to collect the debt at the best conditions in the market? Am I able to reach the different debt providers further to banks?
- How can I increase take up and sell price of my project, compared to the development pipeline and competition in my catchment area?
- Are the marketing strategies and tools I have planned efficient?

At EY, we have developed integrated solutions and tools to help developers and investors in the assessment of their pipeline and for a successful investment journey in the residential development market.
Market assessment and key business plan inputs

Catchment area assessment

Population (cumulative) | Families (cumulative) | Income index | Consumption index | source: urbistat
---|---|---|---|---
72,888 | 282,742 | 2,10 | 114 | Actual / forecast
24,300 | 135,256 | 2,10 | 114 | Actual / forecast
12,300 | 123 | 2,10 | 114 | Actual / forecast
11,400 | 114 | 2,10 | 114 | Actual / forecast
7,200 | 72,698 | 2,10 | 114 | Actual / forecast
2,864,731 | 2,500,000 | 2,11 | 108 | Actual / forecast
4,340,474 | 4,000,000 | 2,20 | 105 | Actual / forecast
5,888,472 | 5,500,000 | 2,24 | 103 | Actual / forecast
60,665,551 | 58,000,000 | 2,35 | 101 | Actual / forecast

Transaction market

---|---|---|---|---|---
Capital city: Roma | Province: Roma | Province: Lazio | Italy
SINGLE ROOM HOUSES | TWO ROOMS HOUSES | THREE ROOMS HOUSES | FOUR ROOMS HOUSES | FIVE ROOMS HOUSES

City: Roma Province: Roma Region: Lazio Italy

Affordable value

---|---|---|---|---|---|---|---|---|---
Market values: 3,200 – 3,800

Take up

Transaction per Year: 50 - 70

Key business drivers

The analysis of catchment area, population trends, transaction market and development pipeline provides input for the business plan exercise.
Marketing & communication - focus

The main goal achieved was to outline an innovative and disruptive approach for the real estate market.

Thanks to the partnership with One Shot Lab, we have built up a new integrated model focused on a 3-phases go to market strategy, together with an omnichannel communication strategy based on a strong brand positioning supported by a concept.

This model concentrates its efficiency in circa 68 days activity divided in 3 steps: Product teaser, Product reveal and Price reveal. The integration of the lead generation action in the process has successfully contributed to maximize the impact on our two targets: stakeholders and prospects.

Hereunder the representation of the model synergy with the important results achieved in terms of sales, and in the next pages our best-selling case histories.
Our Results

EuroMilano & UpTown case history

The itinerary below shows the most effective communication actions, starting from a strong brand positioning, and deliverables we have been producing along the 3-phases strategy to achieve impressive results: 81% of apartments sold in just six months of activity (41% were obtained only in the 3 days launch event).

RESULTS:

41% of sold apartments during the 3 days launch event (9-11 June)

+40% from 12 June until today. The % refers on a total of 140 apartments, not built yet.
This is a particular case because strategy and actions have been condensed in 45 days activity. Nevertheless the results are impressive: 62% of apartments sold in just 3 days event.

RESULTS:

62% of sold apartments during the 3 days launch event (1-2-3 December)
Contacts

Marco Daviddi
Partner
Lead Advisory Services Leader and Real Estate Leader
Italy
Marco.Daviddi@it.ey.com

Rita Neri
Partner
MED Marketing and Digital Communication Leader
Italy
Rita.Neri@it.ey.com

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