AN ANALYSIS OF ITALIAN PROPERTY MARKETS

by Alberto M. Lunghini, Jr., CRE

Editor's Note:
In recent years, the number of countries represented in The Counselor's membership has increased significantly. The organization now has members in Canada, England, Mexico, Japan, Italy, Korea, Australia, New Zealand, Austria, France and Switzerland. In concert with this trend, recent editions of Real Estate Issues *have featured articles on Mexico and China. This edition presents an article on the current and future economic conditions in Italy by Dott. Alberto M. Lunghini, CRE. Lunghini is an engineer and architect by education and a Counselor of Real Estate (CRE) by profession.*

Even though Italy is a member of the G-7 and one of the world's major economies (roughly equal in size to those of Great Britain and France), it is often overlooked by international investors and analysts. While we might think of reasons for this lesser degree of attention (political uncertainty, language, et al), the fact remains that the Italian economy, particularly in the North, has been and continues to be strong and stable. The standard of living in northern Italy is among the highest in the world.

Economic recovery is now a characteristic of almost every major industrialized country; in Europe growth has achieved a certain consistency thanks to the newly expanding economies of Germany and France. In Italy the major driver of economic expansion is foreign demand for its exports, even though the worsening exchange rate is making itself felt through higher prices of imported goods and services.

Despite export growth and other positive signals in the economy, employment is not expected to improve before 1998. In large part this is due to the widespread uncertainties in the Italian economy from political instability and the high level of public debt. A study by DRI/McGraw-Hill of GNP trends from 1993-1998 placed Italy (average annually growth of 1.8%) in the lower ranks of major world economies (Figure 1). However, it should be remembered that between 1950 and 1980 Italy's GNP grew faster than the European Union average. Unfortunately, 1.8% of GNP growth is not sufficient to guarantee a significant decrease in the unemployment rate. (The employment absorption threshold for GNP growth is 2.2%-2.3%.)

Italy always has been known for its strong rate of savings largely dedicated to residential

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FIGURE 1

Five Years Of Growth
(Annual % variation of the GNP, 1993-98)

China	8.2
Asia (Japan excluded)	*7.3*
Malaysia	6.9
South Korea	6.6
Taiwan	6.4
Chile	5.7
Mexico	5.6
Argentina	5.1
Latin America	*5.1*
Brazil	4.7
Canada	4.0
Australia	3.3
Ecuador	3.3
World (general average)	*3.2*
Japan	3.1
Great Britain	2.7
U.S.A.	2.6
Europe	*2.1*
Germany	2.1
Sweden	2.1
France	1.9
Italy	1.8

Source: DRI / Mc Graw-Hill

(to a lesser extent, commercial) real estate. Even considering second and third homes, 75 percent of Italian families own their own homes, one of the highest rates in the world. Italians traditionally have invested 50% of their global wealth in real property while the average debt level for new home purchases remains below 30%.

In the next few years Italian household saving levels should decrease as real disposable income falls. A growing part of this savings will not be managed directly but rather entrusted to organized forms of investment, e.g., pension funds, investment funds, life insurance and annuities, etc. This new kind of Italian investor, more professional and financially-minded than the traditional private investor, will approach real estate markets differently. Investments will be directed exclusively toward property and developments that are capable of guaranteeing high yields with primary leases.

History And Forecasts

An analysis of residential real estate prices in constant 1963 lira (Figure 2) illustrates a cyclical progression since 1962. Initially the cycles contained price growth periods shorter than price contraction periods (usually two or three times as long). As the real estate market becomes increasingly sophisticated, the contraction period should shorten until it becomes more or less equal to the growth period. The 1990s represent the turning point of this structural change. The forecast for the next few years in Italy is that prices will continue to fall through 1996 when a discernible recovery should begin.

A comparison of inflation, real estate prices and the yields of BTP treasury bonds from 1970 to the early 1990s shows that real estate prices earned higher yields than Italian treasury notes during periods of high inflation (1970s). In the 1980s BTPs gave higher average annual yields than real estate investments. A comparison of cost of living increases with real estate prices shows that from 1970 through the 1990s the cost of living index rose significantly slower than real estate prices (Figure 3).

Interpretative Model

An analysis of price cycles and transactions from 1962 to the present shows that the Italian experience has followed the general pattern of real estate cycles (Figures 4 and 5). After a crisis prices remain stable for a time as the number of transactions increases. When the equilibrium breaks, the number of transactions continues its upward climb as prices begin to rise. As prices increase demand is suppressed in the medium-to-short-term. The number of transactions falls as prices remain stable and then collapse generating overall stagnation for supply and demand. The crisis ends not when prices stabilize, but when the number of transactions begins to rise. An increase in the number of transitions, even if prices continue to fall, is positive and preannounces the growth part of the cycle. This model is valid for sales transactions and rental contracts. In Italy's 1995 property market, both prices and the number of transactions continued to fall. In 1996, however, it is expected that prices will stabilize and transactions escalate and that by 1997 both prices and transactions will begin to increase.

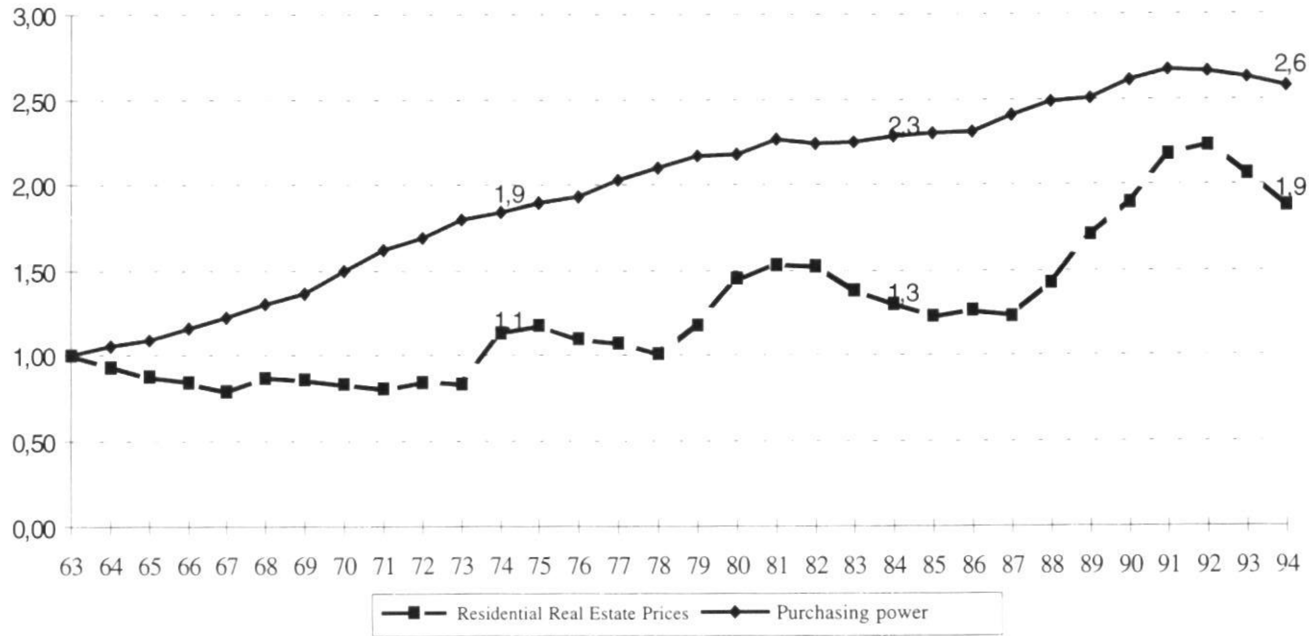
The Residential Market

The variation in real purchasing power (corrected for inflation) of the average worker is a key element in forecasting residential real estate prices. In the last 30 years Italians have increased their real purchasing power by 200 percent and real estate prices have matched every step of that increase.

Forecast data relating to GNP and real purchasing power, taking into account increases in the tax load, justify the hypothesis that private investment development will be less dynamic than in past decades. This also will limit private investments in the non residential sector, particularly for smaller properties (shops, small offices). Unless inflation should explode, a rapid recovery in residential prices is not foreseen in the near future.

FIGURE 2

Residential Real Estate Prices and Average Italian Employee Purchasing Power (1963-1994, both in real term 1,00=1963 values)



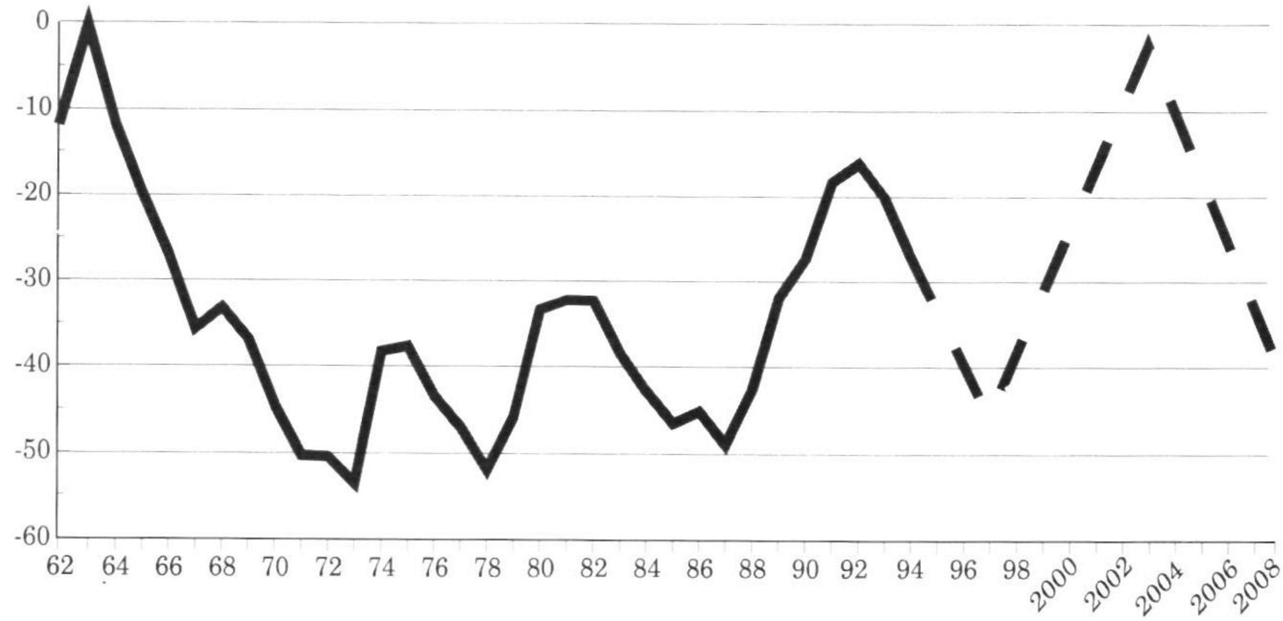
Source: ISTAT, Centro i

FIGURE 3

Cost of Living and Real Estate Prices

FIGURE 4

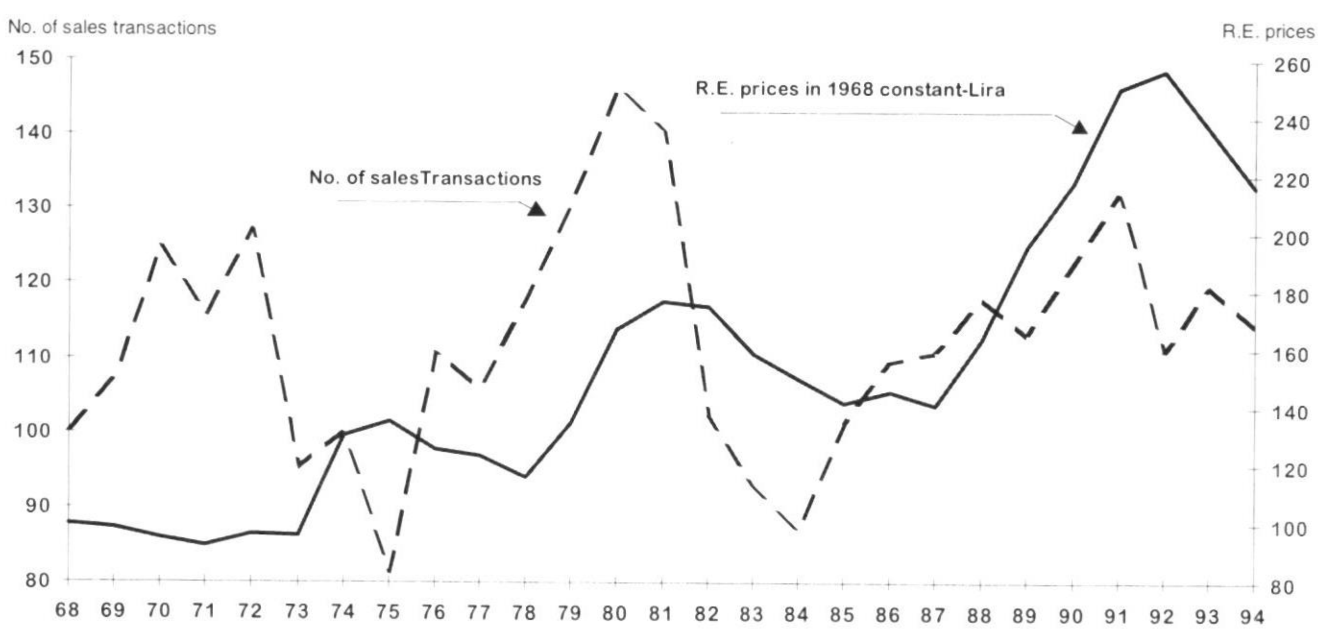
The R.E. Prices Cycles In Italy (1962-1994)
(Without allowing for inflation increase in purchasing power of middle class Italian employees [costant-Lira 1963] [1995-2008: forecast])



Source: Banca d'Italia, ISTAT, Centro i

FIGURE 5

Real Estate Prices Vs. No. of Sales Transactions in Italy (1968–1994)



The Commercial Market

An analysis of trends for office prices, rents and yields in central Milan, Italy's economic and financial capitol, is fundamental to understanding the future of commercial property in the entire peninsula. Economic trends in Milan and in Italy's political and administrative capital, Rome, usually are a precursor of what the future holds for the remainder of the country.

An analysis of price and yield movements illustrates that at the end of a crisis, sale prices tend to remain stable while rents tend to rise. This is the perfect situation for initiating investments with annual yields in the 7 to 8 percent range for centrally located offices. The moment when the crisis in the market is over, sale prices rise rapidly exceeding the increases in the rental price. Subsequently, yields collapse, which, in turn, leads to price corrections in the medium term. This last phase is currently underway in the Italian market. Some sectors currently indicate sale prices 50 percent below 1991 levels or lower. The situation does not appear ready to improve since, in the short term, banks, businesses and public entities are expected to unload numerous properties. This will increase supply and generate price decreases for the next 12 to 24 months, particularly in commercial property. By the year 2000 a solid recovery in sale prices is foreseeable, especially for buildings and complexes that could interest large institutional investors, such as REITs and other real estate investment funds.