Italian Property Snapshot

Aberdeen

The economy

Recent performance

Italian GDP increased by a firm 0.5 % in the first quarter of 2010, after a weak outturn over the previous three months. Against a year earlier, output was up 0.6 %, slightly higher than the eurozone. However, Italy suffered a deeper contraction in 2009, reflecting in part, the lack of government fiscal stimulus. In contrast to the rest of southern Europe though, the economy is in better health, with a much lower budget deficit and a lack of marked economic imbalances, particularly in the area of private sector debt.

Recent strength in the economy has been mainly driven by inventory building and rising exports. On the other hand, domestic spending is in the doldrums. Retail sales showed little change in recent months and the recovery in consumer confidence has been lacklustre when compared to the depth of the downturn of the past two years.

The unemployment rate rose to 8.8 % in March, up 1 pp from 12 months earlier. However, the rise has been contained by a wage supplementation scheme to keep under-utilised workers on company books. A large number of workers will come off these schemes during this year, and the risk is that the rise in unemployment has just been deferred.

Rising oil prices have pushed up headline inflation, although underlying inflation is also picking up, against the trend of a marked deceleration in the rest of the eurozone. Higher relative price inflation is bad news for competitiveness, which has weakened progressively in the past decade against the main competitor countries of Germany and France.

Economic outlook

Italy's ongoing budgetary position is better than that of the peripheral eurozone countries. Nonetheless, the government has announced substantial fiscal tightening for 2011/2012 as financial markets have begun to focus on Italy's high stock of government debt.

The IMF is projecting that public debt will reach 125 % of GDP by 2015, staying the third highest in the industrialised world. Italian government bonds had a premium of over 100 basis points compared to German bunds by end May, almost double that of last autumn, and indicates a high degree of investor nervousness over contagion risks from the rest of southern Europe. Relatively high bond yields will act as a drag on the economy, and business confidence measures showed a notable deterioration in May, relative to the eurozone.

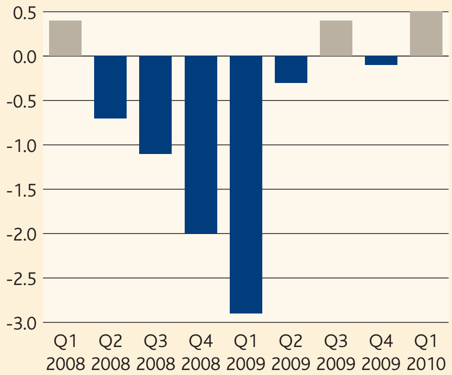
The euro's recent depreciation against the US dollar is positive for exporters, although with 50 % of output sent to the rest of the eurozone, the benefits to the economy will be mild. Underlying structural problems of the economy, namely a specialisation in products with relatively low value added, will continue to lead to an erosion of competitiveness and loss of market share in the global economy. The outlook is for a 1 % rise in Italian GDP this year and 0.7 % in 2011, underperforming the eurozone once again, although better than the rest of the southern Europe, aided by low levels of household debt.

Economic Forecasts

	2009	2010	2011
Real GDP growth (% p.a.)			
Italy	-5.1	1.0	0.7
EU 27	-4.2	1.4	1.1
Inflation (% p.a.)			
Italy	0.8	1.5	1.4
EU 27	0.7	1.5	1.5
Consumer spending growth (% p.a.)			
Italy	-1.8	0.7	1.2
EU 27	-1.5	0.6	1.4
Unemployment rate (%)			
Italy	7.8	8.7	8.7
EU 27	9.0	9.8	9.8

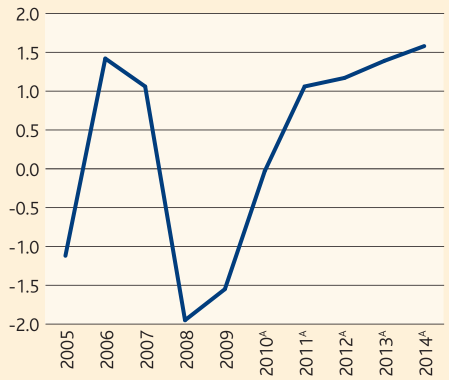
Source: Aberdeen Asset Management

Italian GDP-growth (% quarter-on-quarter)



Source: Eurostat

Location-based retail sales (% annual change)



[A] Forecast
Source: Oxford Economics

Italian Property Snapshot

Recent property market trends

Offices

The effects of the financial market crisis are also reflected in the Italian office market. In 2009, the occupier markets were characterised by declining demand. Tenants preferred to prolong rental agreements and space optimisations, while taking advantage of incentives; in addition, the supply of space increased, resulting in falling rents.

In the first quarter of 2010, the two office centres of Rome and Milan recorded low take up volume, even though increases of 20 % and 2.5 % respectively, were realised in comparison with Q1 2009. In both markets, lettings of large volumes of space were the exception, while contract conclusions for less than 500 square metres dominated the market. In contrast to 2009, the demand in Rome was not concentrated in the CBD, but rather on the southern corridor with Esposizione Universale Roma, Laurentina and Fumicino. As in 2009, the peripheral areas, with good subway connections, were dominant in Milan even though a slow recovery of the central submarket is to be perceived. The latter profits from an increased demand from the banking and financial market sector. Going forward, Semicentro will gain increasing importance, due to imposing projects such as Porta Nuova and CityLife, which all fulfil the LEED environmental standard. In line with a negative absorption of space, the vacancy rate continued to increase and now lies at 6.2 % in Rome and 9.2 % in Milan. In particular, this is due to the completion of speculative projects, whereas in Rome some projects were postponed. For the first time since Q1 2008, prime rents remained stable in Rome and Milan during Q1 2010, even though these were bolstered by incentives, so that the effective rents currently are approximately 10 % below the nominal rents. However, overall, a reduction of 5.3 % and 4.0 % was observed in comparison to the previous year. We still expect a further decline in the rental price level during the rest of this year.

Retail

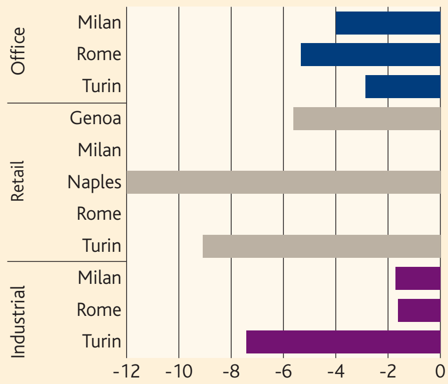
In line with the economic climate, retail sales also fell in Italy. Despite a slight economic recovery, growth is also not to be expected over the year. Nevertheless, some major retailers are already reporting a slight increase in turnover at the beginning of the year.

Prime rents in Milan's and Rome's best locations have remained stable during recent quarters, while in contrast, other centres and secondary locations had to accept rental losses. Shopping centres continued to be amongst the most successful retail formats in Italy. According to JLL, these amounted to 15 million square metres (GLA) at the end of 2009. Traditional shopping centres accounted for an 88 % share, retail parks, 6 %, the increasingly popular factory outlet centres, 4 % and others with leisure facilities, 2 %. In the meantime, shopping centre density has increased to an average of 263 square metres per 1,000 inhabitants. From a regional point of view, the north has the highest density, of about 340 square metres per 1,000 inhabitants. Despite a gradual increase in construction activity, the economically underdeveloped south only has a density of approximately 170 square metres per 1,000 inhabitants, and the weakest investment demand is also recorded here. Due to the restricted financing terms, large lot sizes of over €100 million are proving difficult to sell. At the beginning of the year, prime yields in the fashion centres remained stable compared to last quarter.

Industrial

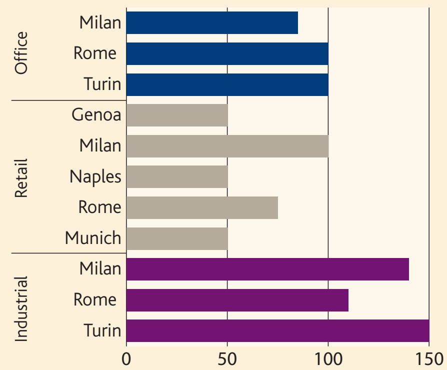
Following a rental decline, also recorded in the industrial sector, the rental values bolstered by the provision of incentives, have stabilised during the past two quarters, above all in the prime markets of Rome and Milan.

Prime rental change Q1 2009 - Q1 2010 (in %)



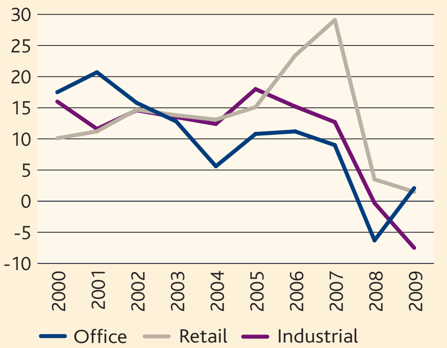
Source: Aberdeen Asset Management

Prime yield shift from peak to Q1 2010 (in basis points)



Source: Aberdeen Asset Management

Prime total return Italy office, retail and industrial 2000-2009 (in %)



Source: Aberdeen Asset Management

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Recent property market trends

In principle, the extension of existing rental agreements and consolidation into more cost effective space has determined the market. As a consequence, the volume of vacant space has increased. Meanwhile, demand for prime products and larger space has begun to revive. Due to the gradual increase in market activity, we anticipate prime rents will remain stable this year. Although transaction volumes increased significantly in Q1 2010, compared with the previous quarter (+107 %), the number of deals was nevertheless very limited. Investors remain interested in core properties. Prime gross yields remained stable, at 8 % in Rome and Milan.

Investment market

As with other investment markets globally, Italy also had to suffer significant losses in transaction volumes (from the boom year of 2007 to 2009, about -52 %). However, a recovery was seen in Q4 2009. A slight increase in investor confidence - despite continuing difficult financing terms - was illustrated by a transaction volume of €1.7 billion. However, this good result could not be maintained during the first three months of 2010, with volumes close to €690 million, and a certain reticence is spreading again. However, this reflects typical seasonal patterns and only amounts to a fall of 6 % compared with Q1 2009. The high volume deals, such as the shopping centre, Porta di Roma, with a volume of approximately €400 million, which had been prepared in advance and were completed during the second quarter, provided a greater level of confidence. As such, we anticipate a moderate increase in transaction volumes by the end of the year, compared to 2009.

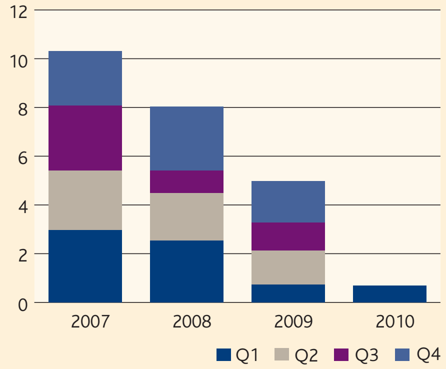
The office market sector, at 55%, dominated significantly in 2009. In regional terms, the investment centres of Milan and Rome were also the leaders, with about 55 % of total transactions. With regard to the office sector, Milan dominated activities. In contrast, the investment volume was distributed relatively evenly across all sectors during Q1 2010, led by the large group of niche sector investments (hotel, residential etc.) with 38 %, followed by retail with 24 % and offices with 19 %. Industrial, which trailed significantly at 3 % in previous quarters, also achieved 19 %. The investment market was dominated by local investors, even though the retail sector is, once again, seeing an increase in interest from international institutional investors. Above all, private equity players dominated purchasing activity. The focus here was on core properties in prime markets.

During the first quarter, the increasing demand for core products has already led to declining prime yields for office properties in the investment centres, compared to the previous quarter. Thus, after four stable quarters, the gross prime yield in Milan fell by 25 basis points, to 5.85 % and in Rome by 10 basis points to 6.10 %. In contrast, prime yields in the retail and industrial sectors remained stable during the past quarters. However, secondary locations and products will continue to remain under pressure and provide a higher yield level.

Outlook

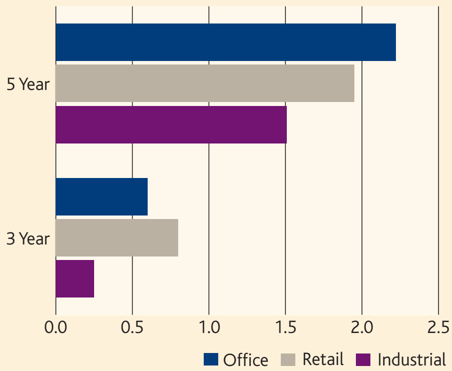
With a slight recovery in demand and concentration on core properties, we expect 2010 prime yield decreases of 30 basis points in the office sector, 20 basis points in the retail sector and 30 basis points in the industrial sector, compared to 2009. An average prime total return (All Property) of 6.2 % is to be expected during the next five years. Thus, Italy occupies a good position amongst its rather more poorly performing southern European neighbours (5.6 %).

Investment volume Italy (EUR billion)



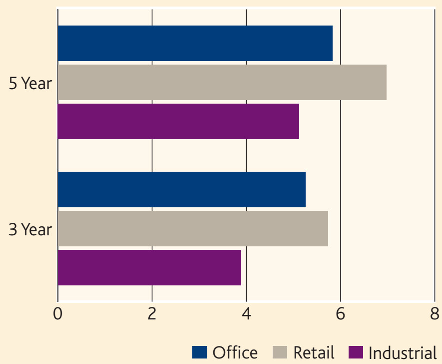
Source: CBRE

Prime rental forecasts Italy from Q2 2010 (annulised %)



Source: Aberdeen Asset Management

Prime total return forecasts Italy from Q2 2010 (annulised %)



Source: Aberdeen Asset Management

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Aberdeen market view

The table below shows Aberdeen's recommended positions on the Italian commercial property market, relative to the benchmark (Italy Total Return All Property), in order to achieve outperformance over a five-year period.

Sector	
Italy office	Neutral
Italy retail	Overweight
Italy industrial	Underweight

Note: Sector weightings are based on the annualised (from Q2 2010) prime five year total return forecasts: All property 6.2%, Italy offices 5.8%, Italy retail 7.0% and Italy industrial 5.1%.

Source: Aberdeen Asset Management

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