Market report
Milan investment

June 2015

SUMMARY

Market activity has not reached its full potential yet

- The Italian economy is the eighth largest in the world, but economic growth remains anaemic. An improvement of financing conditions and a more positive economic outlook have boosted business confidence this year.

- In the first five months of 2015 77% of the investment volume is secured by international players, who show renewed confidence in the market.

- Equity Funds, Sovereign Wealth Funds and other institutional investors from the US, Middle East and Asia-Pacific have overthrown the European investors from their dominant position in the market targeting iconic assets and large portfolios.

- Strong demand and improved pricing expectations underpins the supply of product in the market, which may come from banks, distressed sellers and funds close to expiry.

- Besides portfolios, prime offices in Milan CBD are the most sought after product followed by prime regional shopping centres.

- Investors can benefit from further yield compression as prime achievable yields are 100-200 bps above the previous cycle peak.

- There is increasing availability of financing and margins are coming down, mainly due to lower spreads on the government debt.

"The entire spectrum of players are currently active in the market and the gap between buyer and seller expectations is closing" Gianni Flammini - Savills Italy

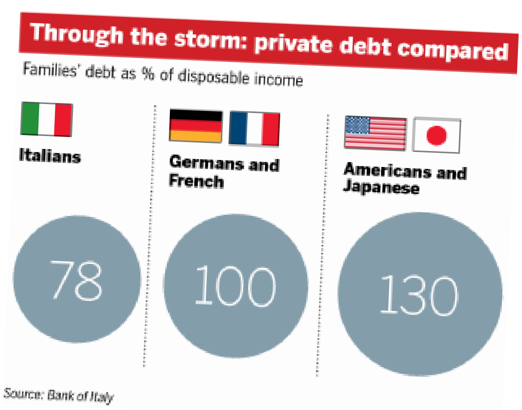
Eighth largest economy in the world, but growth remains anaemic

Italy's economy is expected to return to growth in 2015. The depreciation of the euro should be the key factor that will push the real GDP's growth to a marginal growth of 0.3% in 2015 and up to 1.0% in 2016.

Consumer price inflation has dropped significantly in 2014 due to the weakness of the domestic demand and the fall in commodities prices and in particular of the oil price. In 2015 the inflation should remain on average stable or slightly drop into negative territory. The fall in energy prices is expected to be counterbalanced by higher import prices in consequence of the depreciation of the domestic currency partly due to the Quantitative Easing (QE). This fact, combined with an expected growing of the energy prices should push the inflation up to 0.6% in 2016.

Italian financing conditions are improving compared to previous years but the access to credit for large companies has been more favourable than for small size companies and private sector.

The normalisation of financing conditions, together with the slight reduction of the uncertainty on economic prospects are giving boost to private investment, including construction. The Italian business confidence index increased to 103.7 in March 2015 from 100.5 in February 2015 and from 99.6 in December 2014. Moreover, consumer confidence reached 108.2 in April 2015 (after a peak in March of 110.7), a value that is significantly higher compared to the value of 99.9 registered in December 2014.



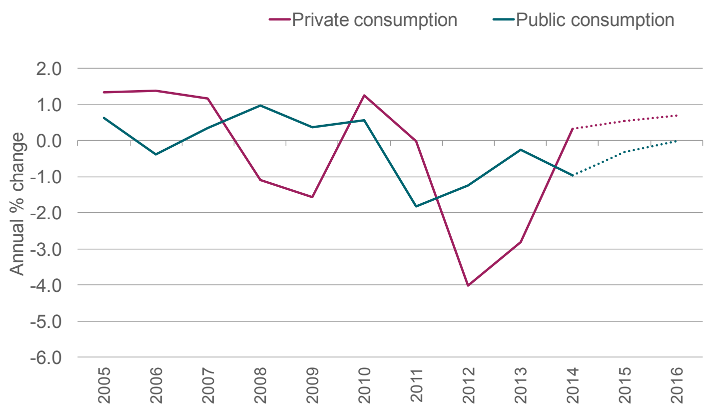
GRAPH 1

GDP and Employment growth Economic growth is quite flat, labour market is improving

Graph source: Oxford Economics

GRAPH 2

Private and public consumption Consumers will benefit from the plunge in oil prices



Graph source: Oxford Economics

> "Public debt is above 133% of GDP but private wealth amongst the highest in the world" Eri Mitsostergiou, Savills Research

Labour market conditions remain quite stable with the unemployment rate is rather stable at 12.7%. Latest surveys of companies and families prefigure, during next months, a slight improvement of the employment outlook, probably due to the introduction of tax reliefs in January 2015 for new hiring and the introduction of the Jobs Act in March 2015.

International players drive the investment cycle

The dynamic come back of the Italian market is reflected in the investment activity figures of the first five months of the year. The total activity from January to May 2015 was at €4.32 bn and has already reached two thirds of last year's total.

Similar levels of annual activity as in 2014 (€5.86 bn) have been witnessed historically in 2008 (€5.9 bn), while the peak was achieved in 2006 at €8.1 bn.

From the €4.32 bn invested in the Italian commercial real estate market since January 15 (until 15 May), over €3.3 bn was international capital, which corresponds to about 77% of the total, setting a new historic record. Cross border investors are driving the momentum as international capital is moving beyond the core European markets in search for better returns.

The renewed confidence of international investors in the market has already been marked since 2013. Activity was initially driven by opportunistic and equity funds (EF), but there are increasingly more entries in the market by institutional investors and sovereign wealth funds (SWF) from overseas.

So far this year EF (25%) and SWF (28%) are sharing over half of the transaction volume, while the rising share of listed companies and Italian property companies (17%) shows the gradual return of Italian investors in the investment scene. National investors are yet to become more active in the market as the weight of capital in property is still about one third (2014) of the historic record of €4.5 bn in 2008.

In terms of investor origin, Middle Eastern capital (30%) accounts for one third of the invested capital in Italy so far this year, followed closely by US money (28%). Asia Pacific investors are also competing for a stake in the market achieving 8% to date.

The availability and quality of product, the risk perception and local market characteristics lead most investors to the North of Italy and particularly in Milan.

Milan remains the key entry point to the Italian market and the most liquid submarket in the country, accounting for the highest turnover of deals, 56% to date.

Average deal size is getting larger

Transaction volumes are being boosted by significant mega deals that are taking place in the market including single iconic asset transactions as well as sizeable portfolio deals.

The average size of deal has more than doubled in the first months of 2015 compared to 2014 and it stands at 120

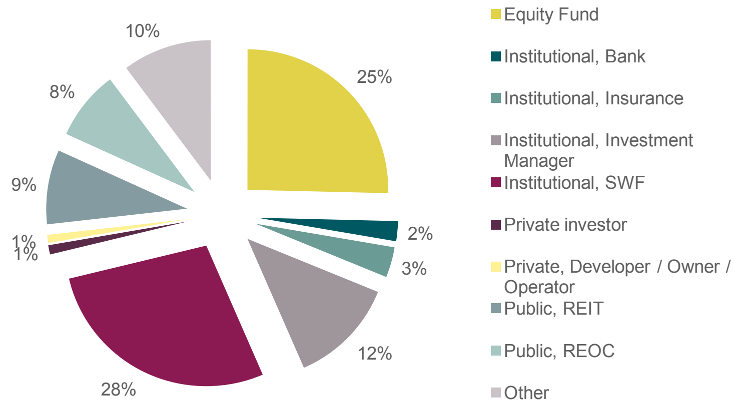
GRAPH 3

Commercial investment volumes in Italy Renewed investor confidence is driving transaction activity

Graph source: Savills *up to 15 May 2015

GRAPH 4

Types of investors Equity funds, Sovereign wealth funds and institutionals account for 70% of activity



Graph source: Savills

OPPORTUNITIES AND RISKS FOR THE ITALIAN ECONOMY

Long-standing issues vs potential improvements

■ **High public debt** - public debt is expected to stay above 130% of GDP until at least 2018. Italy remains vulnerable to swings of investor confidence, with refinancing risks if interest rates rise again.

■ **Low potential growth** - Some structural reforms have been pushed through to boost competitiveness recently, but an ageing population and lower education levels may hold back growth.

■ **Political conditions improve** - Political uncertainty has been a problem for Italy recently. However the current government seems to be stable.

■ **Weak investment picks up** - remains a drag on the economy, however investment increased in Q4 2014 suggesting that recovery is on the way. Investment is still 30% lower than in 2007.

■ **Improving financial conditions** - The ECB easing measures have led to corporate and mortgage rates falling since the start of 2014, while 10-year government bond yields have dropped to the astonishingly low level of around 1.3%.

■ **Depreciation of the euro** - This will improve Italy's competitiveness with respect to non-Eurozone economies, who account for around 40% of total exports.

■ **Depreciation of the euro** - Consumer confidence reached its highest level since 2002 this year and unemployment rate is falling. The labour market could improve further and in conjunction with mild deflation could prompt a stronger pick-up in consumer spending.

GRAPH 5

Economic and political risk structural reforms will improve the risk profile

Risk index (0=no risk, 100=highest risk)	2014	2015	2018
Italy	**42**	**45**	**35**
World average	29	30	27
Sovereign risk	39	40	37
Trade credit risk	67	75	50
Political risk	41	41	36
Regulatory risk	0	0	0

Graph source: Oxford Economics

"Investors from the US, Middle East and Asia-Pacific captured almost 75% of total investments since January 2015. Most of them have only recently entered Italy " Eri Mitsostergiou, Savills European Research

m. This compares to €48 m of the last peak in 2006, reflecting large capital inflows into single real estate lots.

Asian and Middle Eastern investors have invested in trophy assets in the first five months of the year. Qatar Holding completed the acquisition of Porta Nuova mixed use development in Milan from Hines for about €1 bn, which was the largest transaction of the quarter. The second largest deal was the sale of another iconic building, Palazzo Unicredit on Piazza Cordusio in Milan by for €345 m.

Equity fund Cerberus Capital Management continued its buying activity adding two more portfolios on their Italian investments. One was the mixed use Unicredit portfolio acquired for €323 m and the second one was part of the FIP fund portfolio, which was acquired by Cordea Savills on Cerberus behalf for €227 m. Another acquisition by Savills Investment Management and Cerberus regarded the Palazzo Piazza Affari building in Milan for €44 m.

Until May 2015 there have been 12 portfolio transactions on the market, reflecting a total volume of investment close to €2.96 bn. This year the record high of €3.3 bn in 2007 could be exceeded.

Investor demand drives more sales

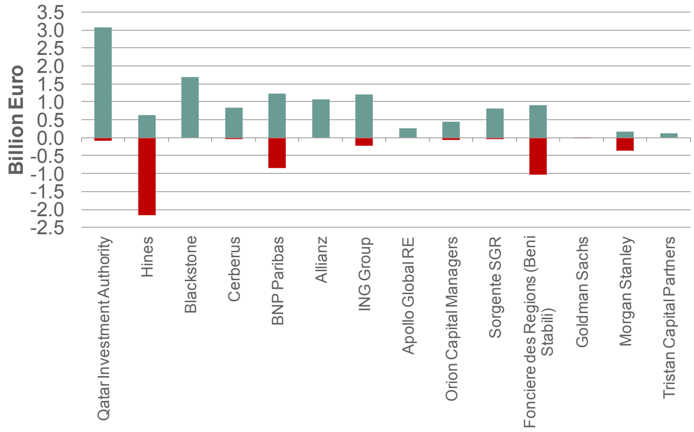
The supply of product in the market is driven by renewed investor interest and improved pricing expectations in the prime segment. Supply of investment product may come from distressed sellers, banks, and funds close to expiry.

There are a number of listed and unlisted Italian funds that are close to expiry, which can bring more assets on the market. In addition many cross border open-ended funds that invested in Italy between 2003 and 2007 are good potential sources of investment.

The creation of a 'bad bank' in Italy, similarly to the creation of NAMA in Ireland and SAREB in Spain would have helped the banking sector to recover faster and restore sooner investor confidence in the market. As this has not happened banks will

GRAPH 6

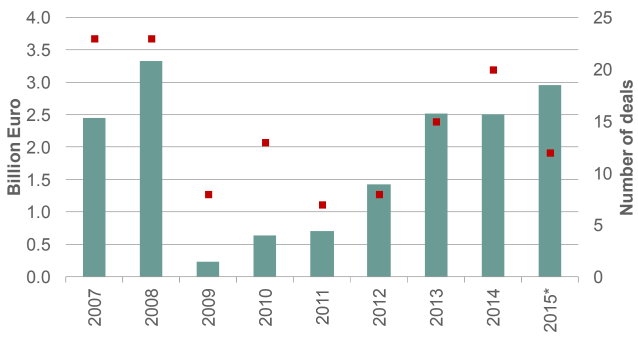
2007-2015 net investments by company Some large new players are active in the market



Graph source: RCA

GRAPH 7

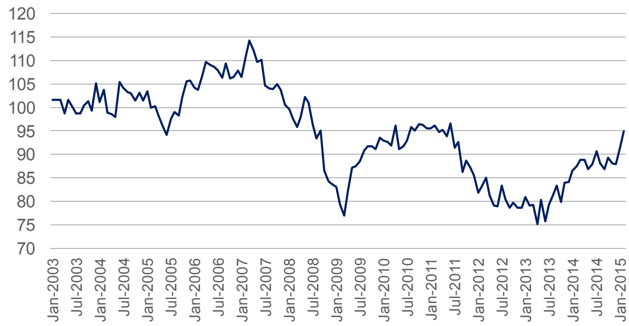
Portfolio activity There is a rising number of sizeable portfolio transactions, more are expected to come



Graph source: Savills, RCA

GRAPH 8

Business confidence indicator Sentiment has reached a four year high



Graph source: Istat

find alternative ways of disposing their assets, through portfolio sales, NPL sales and direct individual asset disposals on the market. The quality of these assets can be mixed and might appeal to investors focusing more on the value add / opportunistic segment of the market.

Italy attracts new cross border investors

The analysis of the acquisition activity of a group of investors that have been present since 2007 in the Italian market we observe that their Italian acquisitions as a share of their total European purchases was at 11% last year. So far this year (May RCA data) this share is at 7% and it compares to a high of 18% in 2008. It is likely that investors may continue to increase further their portfolio allocation in Italy.

The record volume invested in Italy by cross border investors was achieved in 2007 at €5.3 bn. Last year about €4 bn of the investment volume was secured by international players and this level will most likely be exceeded this year.

There is a number of new players in the market who have been net buyers so far and are expected to continue to play a significant role in the transaction activity. Examples include: Blackstone, Apollo Global RE, Allianz and Tristan Capital Partners.

TABLE 1

Two speed market The entire spectrum of players are active. Who are they, what are they looking for, who is selling?

	Core / Core plus	Opportunistic / Value add
Types of buyers	Global Institutional investors Italian Institutional investors Sovereign Wealth Funds	US Private equity firms Asian Investors
Examples of buyers	Invesco RE, AXA RE , UniCredit Banca, Generali Group Qatar Holding, Fosun	Carberus CM, Blackstone Group, Tristan CP
Pricing expectations	Government bond yield + 150-200 bps Positive yield spread with German prime assets	Government bond yield + >300 bps
Investment strategy	Mid-long term holding periods Stable income stream / rental growth Capital appreciation	Short-mid term holding periods Catch the cycle and benefit from yield compression
Target product	Prime offices Milan Prime regional shopping centres Prime portfolios	Portfolios across the country Assets with value-add potential through active asset management / refurbishment / redevelopment
Types of sellers	Maturing funds / Institutional investors / Private inves-tors	Maturing funds / Banks / Institutional investors

Key investment deals and yields by sector

Offices accounted for 33% of investments till May 2015

TABLE 2

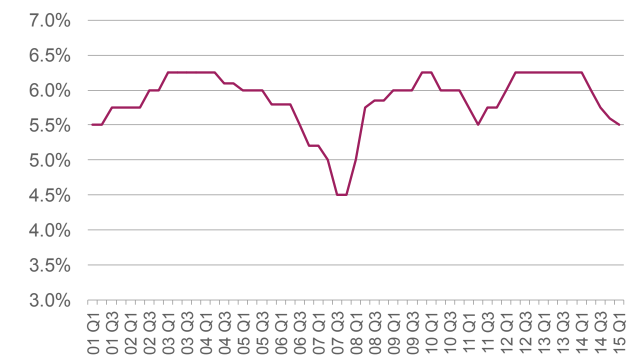
Office investments Q1 - Q2* 2015

Office investment deals	SELLER	BUYER	SALE PRICE (€ MILLION)
Porta Nuova	Hines	Qatar Holding	1,200
Palazzo Unicredit, Milan	IdeA FIMIT sgr / Fondo Omicros Plus	Fosun Int'l Ltd	345
Via Monte Rosa, Milan	Torre SGR Spa	Partners Group	233
Part of portfolio FIP	Investire Immobiliare SGR Spa	Caerberus Capital Management JV Cordea Savills	227
Ex Palazzo delle Poste, Milan	REAM SGR Spa	Blackstone	130
Via della Chiusa, Milan	SEB Asset Management	North Star RF JV Cale Street Partners LLP	157.3
Segro Energy Park, Vimercate	Segro	Hines	118.7
Pirelli HQ, Milan	Torre Sgr	Partners Group	57.8
Via Dei Vecchietti 7-11, Florence	IDeA FIMIT Sgr	UniCredit	55
Via Lancia 55, Torino	Cerberus Capital Management	GWM	32.1

Graph source: Savills, RCA, *up to May 2015

GRAPH 7

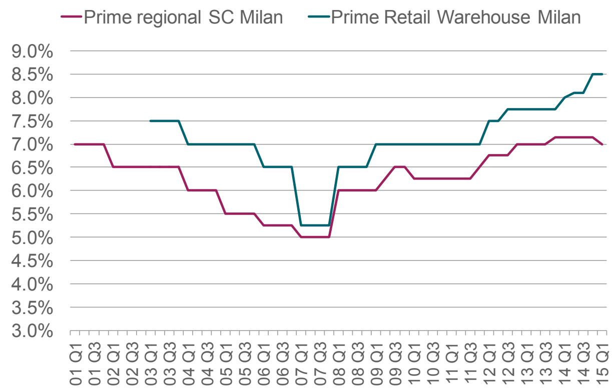
Prime office yields Milan office yields are hardening



Graph source: Savills

GRAPH 8

Prime retail yields Prime shopping centre yields are broadly stable



Graph source: Savills

TABLE 3

Retail investments Q1 - Q2* 2015

Retail investment deals	SELLER	BUYER	SALE PRICE (€ MILLION)
Palazzo Beltrade, Milan	Carlyle Group	Grosvenor Group Holdings	14.3
Immobile Commerciale Catania	Neptunia Spa	Aedes Spa	18.8
Via Rizzoli 7, Bologna	IGD Spa	UBS RE	29.4
Conad Food stores		Sorgente SGR	44.6
Corso Buenos Aires Retail, Milan	Generali Group	Allianz RE	50
Via Torino, Milan	Pria Spa	M&G RE	62.5
Retail portfolio	Altarea Cogedim	Tristan Capital Partners	120
Fiordaliso SC (50%), Milan	Finiper Group	Eurocommercial	135

Graph source: Savills, RCA, *up to May 2015

Besides, over the past three years investors from Canada, China, Hong Kong, Qatar, South Africa, Taiwan, Turkey made their debut in the market, with sizeable allocations of capital. We expect this interest to continue especially when the signs of improvement of fundamentals becomes solid.

Sectors and yields

The acquisitions of the first five months of the year were focused on mixed portfolios as already mentioned, which accounted for almost 70% of the total investment volume.

In terms of single asset transactions, offices accounted for 33% of the activity followed by retail at 12%. Prime offices in Milan usually attract investor attention, as well as good quality regional shopping centres.

Prime achievable office yields (CBD) peaked at 6.25% the previous years and have started compressing since the second quarter of 2014. In Q1 2015 were already 10 bps lower compared to the previous quarter at 5.5% and 100 bps above compared to the previous peak in 2007. Secondary yields for CBD offices were at 6.5% in Q1. Strong capital appreciation trend is combined with a positive turnaround of rental growth. Prime CBD rents increased by 2.1% in Q1 2015.

Prime achievable shopping centre yields have also started moving in, they are at 7.0%, which is 15 bps lower compared to last year but still 200 bps higher compared to 2007 levels.

Finally achievable logistics yields for prime properties in the North of Italy have been stable since last year at 8.25%.

"The yield compression potential of the market will attract more capital in the second half of the year ." Gianni Flammini, Savills Italy

TABLE 4

Why invest in Italy A market that is too big to ignore

- TOP 8 LARGEST WORLD ECONOMY
- DIVERSIFIED INDUSTRIAL PRODUCTION
- CONSISTENT PRIVATE WEALTH AND SHOPPING ATTITUDE
- RECOVERING BANKING SECTOR
- REAL ESTATE FONDAMENTALS, PORTFOLIO
- DIVERSIFICATION, YIELD PREMIUM
- HYSTORY , FASHION, DESIGN AND FOOD

OUTLOOK

Higher flows of capital should lead to further yield compression

■ **Recovery:** Italian economy is showing signs of recovery mainly driven by: stronger external demand, slight increase in domestic demand, improving and more favourable credit conditions for businesses and households. The Italian economy is expected to expand for the first time in four years in 2015, on the back of lower oil prices, expansionary monetary policy and a weak euro.

■ **Renewed investment momentum**: Real estate transaction volumes exceed €5.85 bn in 2014 – 2015 is in the same track. Investor confidence in the political and economic outlook of the country should continue to drive demand for real estate assets in Italy.

■ **Investment availability**: Domestic investors, including distressed private investors and Italian closed-end funds, whose life is about to expire are actively looking for buyers. Moreover, the largest Italian and foreign banks are now more inclined to crystallise write offs by selling off assets.

■ **Investor confidence**: As NPLs have reached around €180 bn, a bad bank is likely to be set soon. This should give a further boost to investor confidence in the market as seen in Ireland and Spain after the creation of NAMA and SAREB entities respectively.

■ **Increasing availability of financing**: Funding capital is now available with many banks including Deutsche Bank, Natixis, ING, Bank of America, Intesa SanPaolo and Unicredit in the market to lend. Financing margins are coming down, mainly due to lower spreads on the government debt.

■ **Timing**: Renewed interest in the European peripheral markets is expected to attract attention from capital sources who are moving up the risk curve over the next 18/24 months. Italy is predicted to capture a large share of this.

■ **Improving fundamentals**: Business confidence has been improving over the past two years, and is in line with its long-term average. Rents for prime assets have stabilised or inched upwards this year for some of the best locations.

■ **Window of opportunity:** While government bond yields and interest rates remain low, investors can benefit from further yield compression as prime achievable yields are 100-200 bps above the previous cycle peak.

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