

France Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

- Rapid inflation in France and the Eurozone has led to rising interest rates and markedly higher borrowing costs. This has had a significant impact on the French commercial property market, bringing a sharp end to the era of record low yields.
- We believe the ongoing price correction creates opportunities for certain value-add strategies. Renovating offices in the CBD and other supply-constrained areas of Paris in order to meet current occupier and regulatory standards, for example, could enable a significant rental uplift.
- Demand for operational residential – including student housing and senior living – is well-supported by city-level demographic and economic trends, and while the yield spread over multifamily residential is compressing, these segments remain attractive.
- Logistics has repriced considerably in the past six months and could provide some tactical investment opportunities for assets in the Greater Paris region and Lyon.

The French real estate market is facing a challenging year ahead. We have seen significant repricing towards the end of 2022 in response to rising interest rates, and while we believe that a large portion of the total correction has already occurred, this process of adjustment is likely to continue early this year. This is particularly the case for the office and retail sectors. However, we see some pockets of opportunity for investment. With planning policy in Central Paris increasingly favouring residential over office use, this is likely to constrain new supply and enhance rental growth in the office sector.

We also see a supply-demand imbalance in the student housing and senior living sectors. The stock of student housing is currently limited, particularly in Paris, where the highest concentration of top-quality universities is located, and rents in the private rented sector (PRS) are often unaffordable. The growth in the over-60s population in France also suggests increasing demand for senior living, which is highly under-supplied at present. And after a sharp correction in logistics values in the final months of 2022, there may also be opportunities here. The possibilities for logistics supply growth around Paris and Lyon remain limited, while occupier demand is still strong, despite the slowdown in consumer spending towards the end of 2022 and early this year.

Recession likely to be short

Although the French economy faces many of the same headwinds as the rest of Europe – tightening monetary policy, erosion of incomes due to inflation – the severity of any recession in the fourth quarter of 2022 and early in 2023 is anticipated to be milder than the Eurozone average.¹ Consumer confidence fell to its lowest ever level in the second half of 2022, and is yet to recover to any great extent;² however,

¹ Oxford Economics, December 2022

² INSEE, January 2023

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the labour market has remained resilient and inflation is starting to ease.

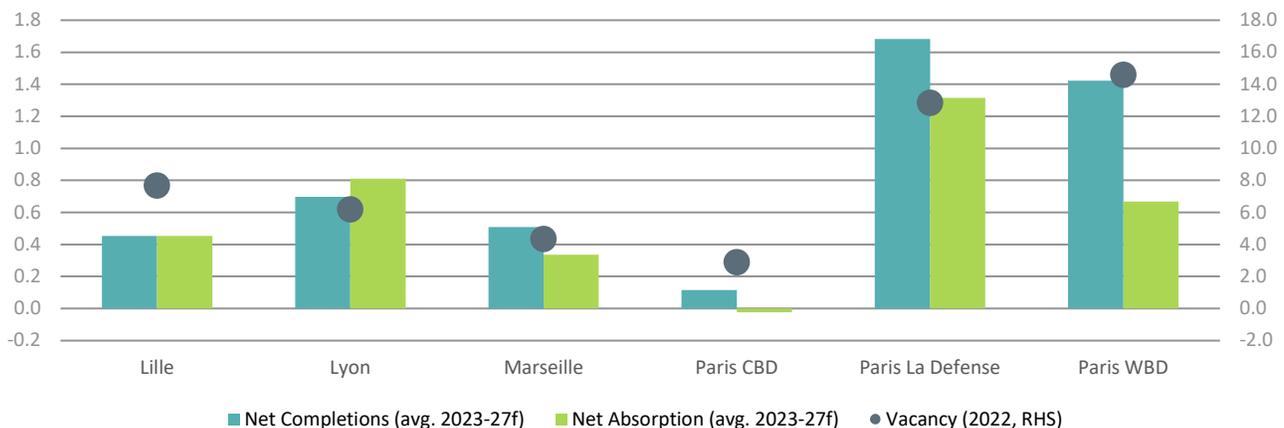
As such, we expect the economy to pick up as the slowdown in inflation continues, falling below target by 2024. The re-election of Emmanuel Macron for another five-year term should allow him to pursue structural reforms to boost economic competitiveness and raise the labour participation rate. However, these reforms are likely to prove complex to implement given that the ruling coalition struggled to push through the budget law for 2023, eventually forcing the bill through the National Assembly without a vote.

Opportunity in value-add office

With prime office yields in Paris CBD starting 2022 at just 2.60%, there was considerable scope for a value correction. At the end of the year, French 10-year government bonds briefly exceeded 3.00% – an annual rise of almost 300 basis points – although the rate has since dropped back slightly.³ CBD yields have moved out by an estimated 80 basis points so far, leading to a capital value decline of 20%, and we are forecasting a further 4% fall in values in early 2023. The regional office markets were slower to respond last year, and we therefore expect to see more price correction materialise in the first half of this year.

Office occupier markets have so far proved resilient. This is particularly true for Paris CBD, Lyon, and La Défense, albeit for different reasons. Paris CBD has benefitted from the trend of occupiers streamlining their office footprints and focusing on the best-quality space in the most prestigious and accessible locations. In Lyon, the regional economy has continued to outperform, driving strong office absorption rates. Rents in La Défense have corrected after a supply surge, attracting occupiers from neighbouring submarkets seeking high-quality, well-connected space at a competitive rental level. However, we have seen vacancy spike in areas such as Northern Paris where occupier demand has failed to keep pace with supply growth.

Office Market Fundamentals (% stock)



Source: DWS, January 2023.

We see the main opportunity in the French office market in future-proofing properties in supply-constrained locations, where a high rent can be commanded to compensate for renovation costs. With minimum energy performance standards requiring non-residential buildings to meet at least energy performance certificate level F by 2027 and E by 2030,⁴ an estimated 52% of office stock in France is likely to be obsolete.⁵ Paris CBD faces an even greater challenge with only just over a quarter of stock completed in the last 20 years.⁶ Low vacancy and

³ Macrobond, January 2023

⁴ As a result of a 2021 revision to the European Energy Performance of Buildings Directive

⁵ Savills, December 2022

⁶ PMA, April 2021

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high rents in this submarket (prime rents reached €960 psm in the third quarter of 2022)⁷ reduce the risk of vacancy on completion of extensive renovation works and increase the potential upside, suggesting a retrofit strategy would be a good fit for this submarket. We see similar dynamics in the 3rd -11th arrondissements, where vacancy is just 2.5% and prime rents are only 15% below the CBD.⁸

Outside Paris, we see limited opportunity to apply this strategy. While rental growth in Lyon has been promising in recent years, we expect strongly increasing supply to weaken the momentum. In Lille, a weaker regional economy has resulted in almost no rental growth for the last 10 years and office vacancy is high at over 8%. In Marseille, a renovation strategy is likely to be constrained by the relatively low rents that occupiers are willing to pay, although the Euroméditerranée area is sufficiently supply constrained to minimise letting risk on completion of any works.

Operational residential a growing focus

Student housing offers attractive entry pricing at a yield of around 90 basis points above prime multifamily residential in Paris, although the spread continues to narrow. The affordability constraints that limit rental growth in Paris's private rented sector offer an opportunity for purpose-built student housing, which can compete on price and offer an all-inclusive package for students arriving in the capital from abroad or elsewhere in France. Paris offers a selection of some of the top universities worldwide including Sorbonne University and Université PSL, attracting students from across France, French-speaking North Africa, and China.⁹ These groups are more likely to prefer purpose-built accommodation for their studies, and applications increased by 18% for the 2022/23 academic year compared to 2018/19.¹⁰ There is currently enough purpose-built stock to accommodate less than 15% of students in Paris, compared to 26% in London.¹¹ In addition, the stock of student housing in Paris is limited in both quantity and quality. The main challenge in this sector is acquiring or creating housing that is sufficiently accessible from the main universities to be attractive for students, when the development opportunities are largely located outside the Intra-Muros area.

Senior housing also offers an attractive spread to residential, with prime yields in Paris currently at around 4.10%.¹² With the over-70s population expected to grow by over 2% per annum for the next 10 years, there is an increasing need for suitable homes for this age group. At present there is only enough purpose-built accommodation in the assisted living sector for 3% of the population over 75, compared to around 7% in the U.S., suggesting there may be considerable scope for growth, not only to increase market penetration but to keep up with demand.

The outlook for PRS is less convincing, however. Across France, the number of permits to construct new housing has been trending up over the past two years, particularly for multifamily, and now stands around 50% higher than the long-term average.¹³ This suggests that supply is catching up with demand and may weigh on rental growth in the near future.

In Paris, over the past 10 years, prime residential rental growth failed to keep pace with the European average. This is partly because of ongoing population movement out of Central Paris and into the greater Ile-de-France region, and partly because of stretched affordability. We expect these trends to persist, weighing on prospects for rental growth. Despite these dynamics, prime residential yields have tended to be among the lowest in Europe. While population growth in the western submarkets of greater Paris is more promising and pricing has corrected significantly over 2022, we do not expect demand to be sufficient to generate rental outperformance.

Logistics once again on the radar

At the start of 2022, prime logistics yields were at an all-time low, and 40% below the 10-year average. Even assuming a strong outlook for rental growth at this point, it had become increasingly difficult to meet return targets at this price point. Now, the sector has repriced

⁷ CBRE, November 2022

⁸ CBRE, November 2022

⁹ Campus France, 2022

¹⁰ Campus France, 2022

¹¹ HEPi, July 2022

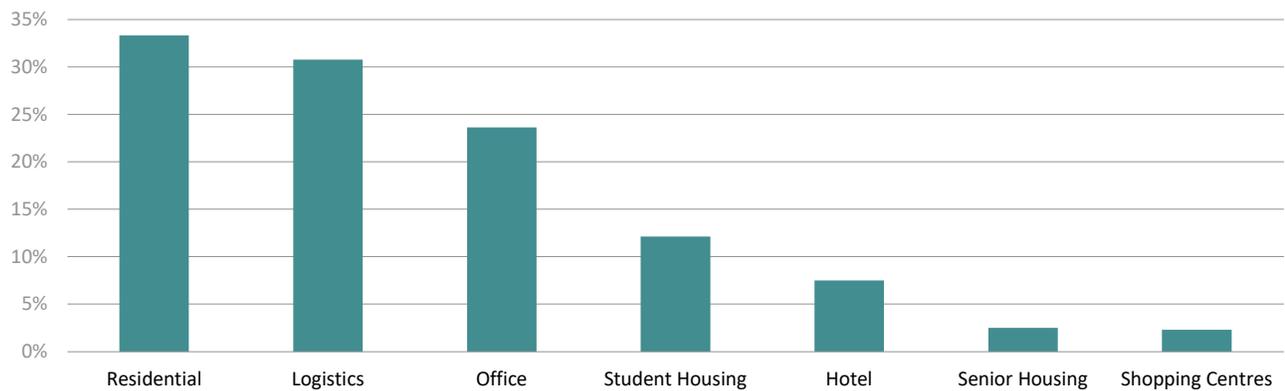
¹² CBRE, December 2022

¹³ BNP Paribas, November 2023

sharply. Yields moved out by an estimated 50 basis points in the final two months of the year, and are currently about 100 basis points above their early-2022 trough.¹⁴ Given the extent of the repricing to date, we expect that yields have almost fully corrected and will stabilise by mid-2023.

At current pricing levels, logistics looks more attractive. While the sector must contend with waning consumer spending, alongside rising energy, labour and transport costs, the long-term fundamentals are good. E-commerce continues to make inroads into in-store sales, driving occupier demand. At the same time, supply is constrained, with vacancy falling by 16% year-on-year across France to reach 3.8% in the final quarter of 2022.¹⁵ The Hauts-de-France region is the only area where supply is keeping pace with demand, with space being particularly scarce around the Greater Paris region and Lyon. This is likely to maintain pressure on rents, and we expect annual growth of close to 3% in these markets over the next three years. With existing logistics stock increasingly dated compared to occupier standards today, we would therefore acquire older stock on a selective basis, undertaking an active management strategy in order to meet current occupier requirements where pricing is sufficiently compelling.

Percentage Change in Yield, May 2022 vs. December 2022 (%)



Source: CBRE, January 2023.

¹⁴ CBRE, January 2023

¹⁵ CBRE, January 2023

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