Knight Frank

PARIS VISION

Commercial Real Estate in the Paris Region
Results & Outlook

2017

INVESTMENT

Champagne Biscuits

EDITO

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CEO Paris Office
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Dear friends,

Corporate real estate once again recorded an impressive performance in the Greater Paris region in 2016.

The year ended with transaction volumes up sharply: the office rental market is again higher than the 10-year average and the investment market recorded its second highest level of activity in a decade.

The retail market attracted even greater interest and represents a growing share of investment volumes.

These performances are all the more remarkable given that the international political timetable created significant volatility, and that French economic growth, although certainly healthier, remained modest.

More electoral landmarks lie ahead in 2017, along with the Brexit negotiations which will kick off in earnest in the spring.

Investor and user confidence remains undaunted, however. All the signs are that 2017 will again be a very active year for real estate with players increasingly selective in their strategies.

I hope you will enjoy exploring Paris Vision 2017, with its new user-friendly format which will help you to locate information more easily. It offers clear insights into the experience of Knight Frank teams on the ground and includes plenty of prospective analysis to help make your projects a success in 2017.

Each of the three sections in this ninth edition – Investment, Leasing and Retail – will also share with you the insights of our main contributors who agreed to answer our questions: Louis-Simon Ferland (Blackstone), Eric Donnet (Groupama Immobilier), Anne-Sophie Sancerre (Unibail-Rodamco) and Raphaël Brault (AEW Europe)

As in each year, Daniel Cohen provides us with his analysis of the global economy in a political climate which has never been so uncertain.

I hope you enjoy it!

OPINION

DANIEL COHEN

Professor and Director of the Economics Department of Higher Normal School (École normale supérieure de Paris)
Founding member of the École d'Économie de Paris
Director of CEPREMAP (Centre pour la recherche Économique et des Applications).

FLEETING GROWTH

THE RECOVERY IN CONSUMER SPENDING IS SET TO CONTINUE, HOWEVER, AND REAL ESTATE IS LIKELY TO RETAIN THE MOMENTUM GAINED FROM LOWER RATES.

French growth reached 1.1% in 2016 and is expected to remain stable this year. This is good news, in that it confirms that the period of stagnation is over. It is also a disappointment, however, since conditions have never been more favourable, considering the combined falls in interest rates, the euro and commodities prices. This rare planetary alignment is unlikely to occur again in the next year. Interest rates will no doubt remain low, despite evidence of a slight upward trend, although the downward cycle in commodities appears to be over. The rise in commodities prices will mean an increase in inflation, which is both good and bad news. This is bad news in terms of household purchasing power and restoration of corporate margins, but good news for the overall functioning of advanced economies, which need a certain level of inflation to keep the economy ticking over and facilitate adjustments, etc. The National Institute of Statistics and Economic Studies (INSEE) is now counting on average inflation of 1.2% for the Eurozone. The recovery in consumer spending is set to continue, however, and real estate is likely to retain the momentum gained from lower rates. According to INSEE, households' real-estate investment could grow by 1.9% in the next year, following a 1.4% increase this year.

The much-anticipated decline in unemployment is also in evidence. In the past 12 months, the number of Category A registered unemployed (i.e. those with no employment who are available for work immediately) has fallen by 125,000 in France, to reach 3.7 million in November 2016. Commercial employment is rising again, at an average rate of 30,000 recruitments per quarter. Unemployment is therefore set to fall, although at a moderate pace considering that the labour force in France is growing at almost the same rate. Based on these criteria, unemployment will ultimately have increased by 500,000 under François Hollande's presidency. Across all categories as a whole (including those on reduced working hours or actively seeking employment) the increase is set to be over a million, only just below the figure recorded during the previous presidency.

These projections are subject to change, however. Never has political uncertainty been greater following a year of unexpected events in 2016. Brexit and the election of Trump shook Europe and the United States. Brexit particularly surprised observers since the United Kingdom is not part of any of the European institutions considered to be responsible for the crisis in France. It is not part of the Eurozone or the Schengen Area. The same resentment was evident in both cases, however, along with the same frustration expressed with the authorities' inability to improve the economic situation. One key statistic which could be seen to summarise all the others is: "Do you think that the next generation will have a better life than today?" Trump won the votes of the 63% who think not...

It is too soon to assess the economic impact of Brexit, but the OECD has already produced some simulations based on Trump's economic policy, which has two aspects: internal stimulus and increased external protectionism. Internally, Trump's programme is likely to stimulate American growth by 0.4% in 2017 and 0.8% in 2018. The corresponding increase in the US public deficit could represent 1.5% of GDP. This will push up the dollar and could be good news for the rest of the world.

The risk posed by protectionism is more difficult to quantify. Over the last 30 years, global trade has grown on average twice as much as national GDP. That is no longer the case, however — their growth is now the same. It is possible that the immense international reorganisation of labour, which began in the 1990s, is nearly complete. Judging from the president-elect's choice of advisors, who are all protectionist, the Trump administration is likely to contribute to the slowdown in international trade. The example set by Ford, which has abandoned plans to create a Mexican subsidiary and will instead expand its existing car plants in Detroit, could serve as a template for the future. Some see this as good news: it will mark the end of globalisation as we have known it for the past 20 years, with the gradual erosion of industrial jobs in developed countries. But the reality is that the economic dynamism generated by the growth in international trade will also disappear. Growth in China, which has now become the world's second largest economy, withstood the impact of the 2008 crisis, benefiting countries such as Germany. If the changes in globalisation become established over the long term, the consequences will be considerable.

The key question is therefore where will growth come from, if no longer from international trade? In November 2016, the OECD published a report expressing concerns over what it called the "low-growth trap". According to the calculations in the report, developed economies' potential growth is falling steadily. It has apparently halved from an average of 2% to just 1%. This is due largely to postponed investments since the start of the crisis… The IMF published a similar assessment not long before. The OECD therefore argues for a concerted revival in public investment, equivalent to 0.5% of GDP, which could boost growth by 0.6%, taking into account the positive effect of public investment on structural growth. Will these measures be enough to avoid the trap of low-growth economies, otherwise known as secular stagnation? If a shock is seen as necessary to finally dispel the crisis, then why not? But if long-term problems are rooted in the weak influence exercised by the digital economy over employment and purchasing power, then much greater inventiveness will be required.

RAPHAËL BRAULT

Managing Director | Head of France
AEW Europe

Knight Frank: AEW enjoys international coverage and has established itself as a major investor in Europe. Can you tell us about the French market, particularly in the Paris region, and its specific characteristics compared with other large markets in Europe and around the world?

Raphaël Brault: France and the Paris region in particular continue to represent a vital market for investors. Taking third place for investment volumes in tertiary real-estate, behind the UK and Germany, France even saw its share of investment grow in 2016 while the other two dominant markets recorded falls.

This healthiness can be explained, among other factors, by the numerous advantages of French real estate, including significant depth and strong liquidity, as well as relatively stable rents which, in some areas, offer the prospect of real, albeit moderate, moderate growth. Furthermore, the transparency and high-quality information enjoyed by our market are valuable tools to help investors' decision-making. By positioning themselves in France, investors have access to a wide range of business sectors, thereby reducing the potential impact of an economic downturn on rental values.

The Paris region is also the largest real-estate market in Europe, far ahead of London and the main German cities. Having benefited from a fairly restrained construction sector since the

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THIS MERGER BETWEEN AEW AND CILOGER IS ENABLING US TO POSITION OURSELVES, IN FRANCE, AS THE THIRD-LARGEST MANAGER OF CONSUMER REAL-ESTATE INVESTMENT VEHICLES.

crisis, combined with a much slower recovery in rental values, the Paris region is finally showing signs of revival in tertiary activity, encouraging investors to look forward to a welcome rise in rents in a European climate in which there is little hope of further growth being generated by lower rates.

KF: Faced with a dearth of core assets and persistently weak prime yields, many investors have turned to alternative assets such as serviced residences, healthcare and hotels, rather than speculative off-plan developments. Do you think this is a sustainable long-term trend? What does it mean in terms of acceptance of risk by market players?

RB: In a low-rate environment, investors will certainly continue to look for yield. Alternative assets provide a partial response to this need, although it is important to bear in mind that the markets in question are of limited depth. It is also important to remember that as attractive as they may be, the property values of these asset classes is more exposed to underlying operational performances. In other words, if activity declines, operators may be less able to maintain rents at previous levels. However, demographic trends – particularly ageing of the population – can only lead to more growth in sectors such as healthcare and residential services for the elderly.

Concerning speculative off-plan developments, it is necessary to be nuanced. Some investors consider that there is not enough reward for the risk taken compared with leased buildings and so avoid these opportunities. We believe that a detailed analysis of the various sectors enables us to position ourselves on projects offering attractive risk-return ratios. For example, a risk premium of 75bp to 100bp on a development in inner-city Paris presenting a vacancy rate of less than 4% is not necessarily a bad bet. The same is true of projects close to transport hubs in areas where tertiary activity is increasing, as demonstrated by our recent experience in northern Paris, near the Parc du Millénaire.

KF: AEW is merging with Ciloger, marking an important step in your development towards consumer savings products. The record inflows achieved by these products are supporting the dynamism of the investment market but they will then need to be invested in assets offering long-term performance. What are the reasons behind this success and what will you do next?

RB: This merger between AEW and Ciloger is enabling us to position ourselves, in France, as the third-largest manager of consumer real-estate investment vehicles.

It is true that individual investors still have a strong appetite for bricks and mortar and these investments are characterised by yields which are generally higher than traditional savings products while providing a form of security and stability as a result of the quality and diversification of the underlying portfolios. In basic terms, real estate offers similar volatility to the bond market and overall long-term yield equivalent to the stock market. That explains why it is so attractive.

The question remains of the significant inflows and the problem of allocating the resulting capital. There again, the merger between AEW and Ciloger adheres to an industrial approach designed to allow the managers of our consumer products to access a range of asset classes via our pan-European geographical coverage, making it possible to remain disciplined while investing the sums collected in high-quality underlying assets, while complying with our diversification objective.

CHAMPAGNE BISCUITS

INVESTMENT

A pink or white Reims biscuit traditionally accompanies champagne, so much so that it is known as the "champagne biscuit" and has come to symbolise celebration. Dipped into glasses of fizz, it tempers the acidity of the wine and prevents the alcoholic effects being felt too quickly, to prolong the fun…

What better way to celebrate 2016 and begin 2017? There were certainly many reasons to celebrate on the investment market, although it is not entirely clear whether the festive mood will continue or whether a hangover is about to kick in.

So, to champagne… and biscuits!

- The investment market continued to achieve record results in 2016, with the Paris Region attracting €19.5bn, up 3% in a year – the second-best result ever recorded.
- French investors are more dominant than ever on their home turf, controlling 68% of the funds invested in the Parisian region.
- International investors were net seller overall, however, stepping up their arbitrages, often cashing in on considerable capital gains. This prevented any risk of drought on the market.
- The "fly to quality" marked 2016 since funds were massively invested in core assets (67% of volumes invested). Office buildings remain prevalent, given the lack of saleable assets, and investors are willing to explore every alternative providing it offers a good level of security, particularly if it includes a retail component.
- In 2016, the market was characterised by the increasing importance of major deals, with the trend being towards concentration. This may pave the way for greater transaction volatility in the future.
- The compression in prime yields continued, as they shed 50 base points in the Central Business District (with rates of between 3% and 3.25% at the end of 2016 and even below 3% for the best assets).
- The real-estate sector continues to offer a significant advantage over bond yields (with a spread of 218 base points in December 2016).
- There is much greater uncertainty as we enter 2017: competition between equities and bonds is likely to become fiercer while the tangible nature of property could mean it benefits from the climate of instability.

TRENDS

Few major changes on the corporate real-estate investment market in 2016. Secret recipes for success were generally re-used, producing results which strongly resembled those of the previous year.

So, will 2017 be another carbon copy? No, it would be wrong to take this for granted. New trends are emerging which could herald changes in the future.

#01 - INVESTMENT VOLUMES

Cream of the crop

A €20bn market, or almost – €19.5bn to be precise. In the Paris region, 2016 ended with excellent results for corporate real-estate investment, even slightly exceeding results for 2015, which were judged to be exceptional. 2016 was a year rich in success!

We look back on the success which almost set a new record for the Paris Region.

This was the second-best result ever recorded on the Paris Region investment market despite real fears for 2016. These fears did not so much concern demand for real-estate assets, which was strong and had every reason to remain so. They related more to the scarcity of saleable assets and the risk of the market drying up. These concerns were nothing new, since they had already led to caution in 2015.

"Thanks to an exceptional second half to the year, investment volumes continued to come close to record levels in 2016, up slightly on the previous year (+3%)."

As in 2015, the market managed to overcome these difficulties. After a mixed start to 2016, which seemed to confirm how difficult it has now become to maintain previous levels of activity, the Ile de France market gradually picked up momentum. With an exceptional second half-year and a total of €19.5bn invested in corporate real-estate assets in 2016, results are up slightly on the previous year (+3%).

"In 2016, international investors took advantage of strong demand in Paris, increasing the number of arbitrage transactions."

The risk of drought was prevented thanks to the acceleration in arbitrage decisions taken by international investors. Encouraged by strong demand on the Paris market, the resilience of prices and prospects of comfortable capital gains, these decisions made it possible to generate €10bn in transactions. The temptation for these international investors to sell some of their Parisian assets was particularly strong since London, the other major European market, proved much more unstable following the Brexit vote. The Americans clearly understood this, selling almost €3.5bn of assets, while the Irish and British received €1.8bn. For example, the off-market sale of 9 Place Vendôme for €1bn by its Irish owners, contributed significantly to the excellent results on the investment market.

Meanwhile, German investors continued the withdrawal which began a few years ago, as part of the liquidation of some of their funds. They sold more than €1.7bn of assets in 2016. Arbitrage decisions were also encouraged by the codicil to the France-Luxembourg tax treaty, which came into force on 1 January 2017, ending effective exemption for Luxembourg-registered companies for capital gains realised from the sale of assets in France. Many domestic and international investors had recognised the chance to cash in, creating numerous Luxembourg vehicles to invest in the French market. If short- or medium-term arbitrage of an asset was planned, it became important to complete the act before the end of

2016 or else become subject to common law, with 33.34% tax on capital gains. This certainly acted as a catalyst for activity in the second half of 2016. The sale of 9 Place Vendôme, mentioned above, is one example, since the sellers owned the property through Luxembourg-based companies.

For French owners, arbitrage decisions were less easy due to the difficulty of reinvesting the capital gains in their domestic market. An activity driver was nevertheless identified among real-estate developers, who benefited from the renewed popularity of off-plan sales, which generated more than €2bn.

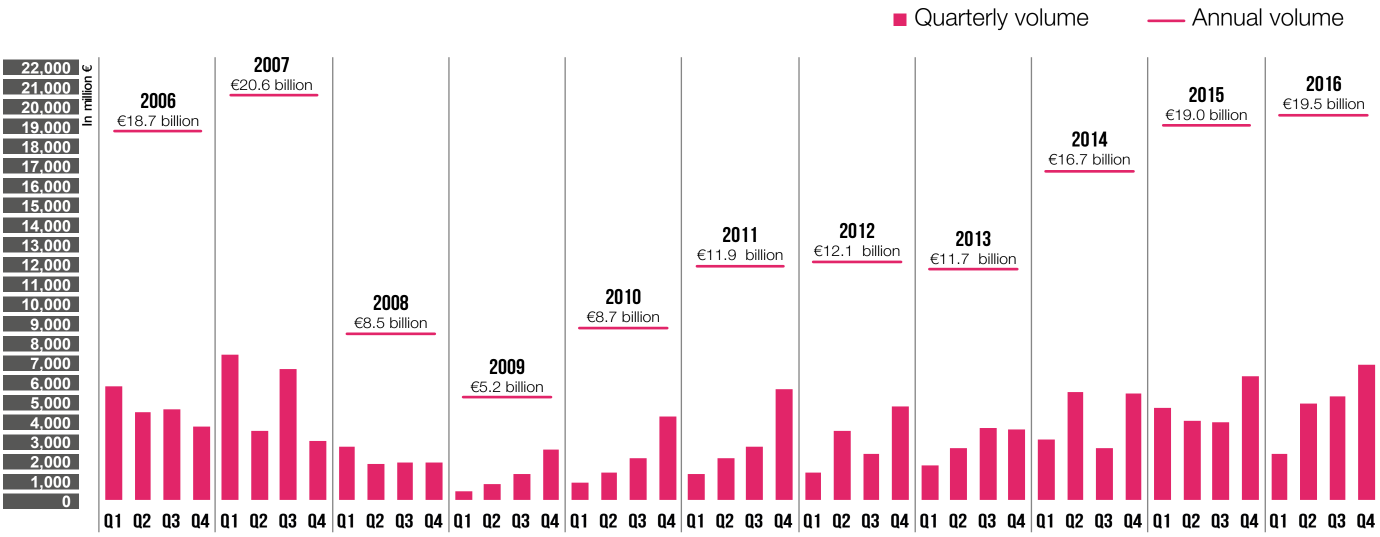
"The codicil to the France-Luxembourg tax agreement, ending exemption from capital gains from 1 January 2017, significantly boosted investment volumes."

Irrespective of the France-Luxembourg tax treaty or taxation of capital gains, demand for real-estate assets remained very strong throughout 2016. And, as in 2015, the most important challenge to overcome was the lack of acquisition opportunities.

In 2015 purchasers looked for alternatives in buildings under development or for redevelopment – more readily accepting the prospect of risk in the Paris Region, where the rental market regularly demonstrates its resilience and depth. However, that was not the case in 2016. The proportion of value-added developments fell to 15% of investment amounts, of which just 3% corresponded to speculative off-plan sales or those without a rental guarantee. No, 2016 was the year for core assets. The core assets category accounted for 67% of take-up in the Paris region, up massively on the previous year (59%). Although this movement was significantly amplified by

Changes in amounts invested in the Paris Region

Source: Knight Frank



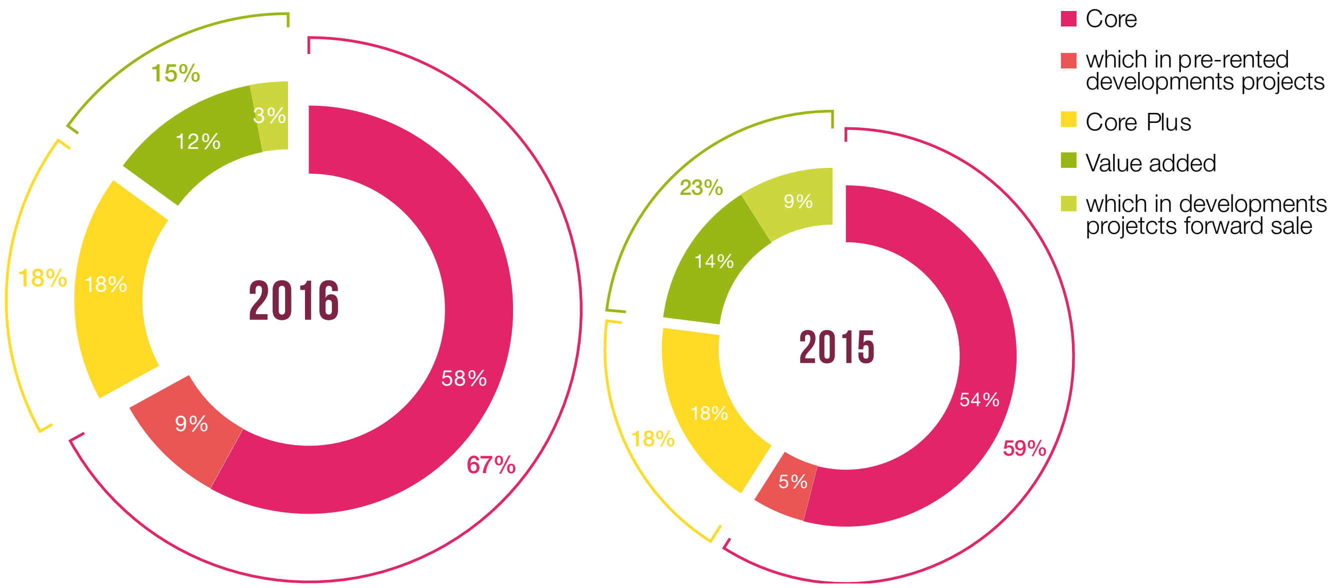
the sale of 9 Place Vendôme in the final days of the year, which alone accounted for 5% of the year's total investment volumes, there was also a definite "fly to quality". The main attraction of Parisian real-estate lies in its combination of security and yield, with the acceleration in pre-lettings on the rental market creating new opportunities to be seized. This is where purchasers came to find alternatives. Secured off-plan sales, which can be categorised as core assets, represented 9% of investment volumes in 2016 – almost double that of the previous year.

"The distinguishing feature of 2016 was a 'fly to quality', reflected in the dominance of core assets (67% of investment volumes). The attraction of Parisian real-estate is its combination of security and yield."

Investors also sought alternatives in assets other than offices. Offices remain dominant, of course, accounting for 83% of investments in the Paris region, but that dominance is weaker than in 2015. Without focusing too much on service properties, such as clinics, care homes and hotels, which are not included in our figures, growth in this sector is remarkable even though it continues to represent niche markets with their own specific operating rules. Hotels have become fashionable assets among investors, for instance. They are popular for their strong annual performance, despite Paris being seen as suffering from a lack of rooms up to international standards to respond

Breakdown of investment activity in the Paris Region by risk profile

Source: Knight Frank



to medium-term tourism demands . Converting an office building into a hotel has consequently become an option frequently considered in the event of obsolescence. One of the most recent examples of this type of transaction is the 4,600 sq m office building on Rue la Boétie bought by simplified joint stock company (SAS) Etoile des Champs (Faure) for conversion into a four-star hotel.

> "The appetite for retail assets is enormous. The share of this sector is increasing, although it remains restricted by a lack of opportunities."

However, the main alternative to core office buildings explored by investors in 2016 was retail properties. This

area attracted almost €2.8bn, significantly increasing its representation in investment activity in the Paris region from 11% to 14% in a year. This performance is particularly impressive since it does not include any sales of large shopping centres. The increase reflects a large number of acquisitions of ground-floor shops as well as entire properties, including a significant proportion of retail, such as 9 Place Vendôme and 65/67 Champs-Elysées.

Investors have a very specific appetite for retail assets located in prime Parisian locations, based on the long-term presence of retailers, the level of demand and the reliability of cash flows. In addition to the examples already mentioned, this is demonstrated by the sale of Saint-Germain market in the 6th arrondissement and of the two assets in the Interstellar portfolio (Rue du Faubourg Saint-Honoré and Boulevard des Capucines).

The Marais is also proving very popular, with a large number of acquisitions motivated by the district's commercial transformation and the potential increase in rental values. Having recorded more modest amounts up until 2016, this year could well see the transformation of the Marais confirmed through market values worthy of the top locations in Paris.

Demand was also sustained for shopping centres in Paris and its suburbs. There is still room for upward movement post-2016 however. Apart from the sale of the Saint-Germain market, few significant transactions were recorded for this asset category, as most of them are owned by real-estate companies that want to hang onto them. Investors turned instead to suburban retail parks, with some major acquisitions including Villebon 2, acquired by ACM and Prédica, in partnership with Immobilière Frey, for €159m.

[1] Le Monde, 1 December 2016; Les Echos, 2 December 2016

"The main difference in 2016 was the investment market's concentration on a smaller number of large deals. This could herald greater volatility in the future."

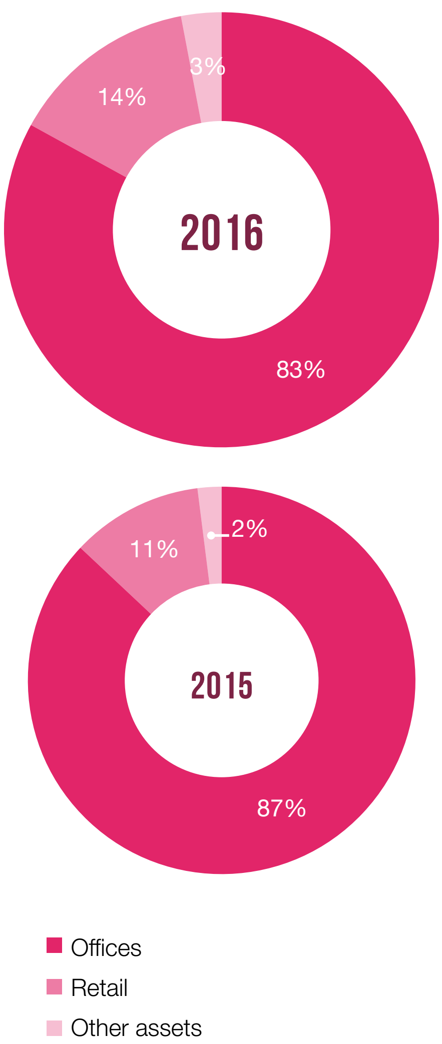
The investment market therefore saw some repositioning, adjustments and adaptations, but little significant change in 2016. There was one major development, however, and it was not a good sign for maintaining current levels of activity on the market. This was the refocussing of the investment market on just a few large sales. Almost half of the market was reliant on just 32 transactions in 2016. It took almost 40 transactions to achieve the same proportion the previous year.

Paradoxically, this market concentration occurred despite an increase in the number of transactions in 2016. There were more acquisitions under €50m, although their overall total did not prevent the category's relative share from shrinking. Sales for more than €100m made clear inroads, however. This segment progressed the most, accounting for 69% of investment amounts in the Paris region through approx. 60 transactions.

Thanks to a combination of favourable circumstances the threat of drought was avoided and investment volumes remained close to record levels. However, market concentration is also a sign of potential volatility ahead. A close eye will have to be kept on the situation in 2017.

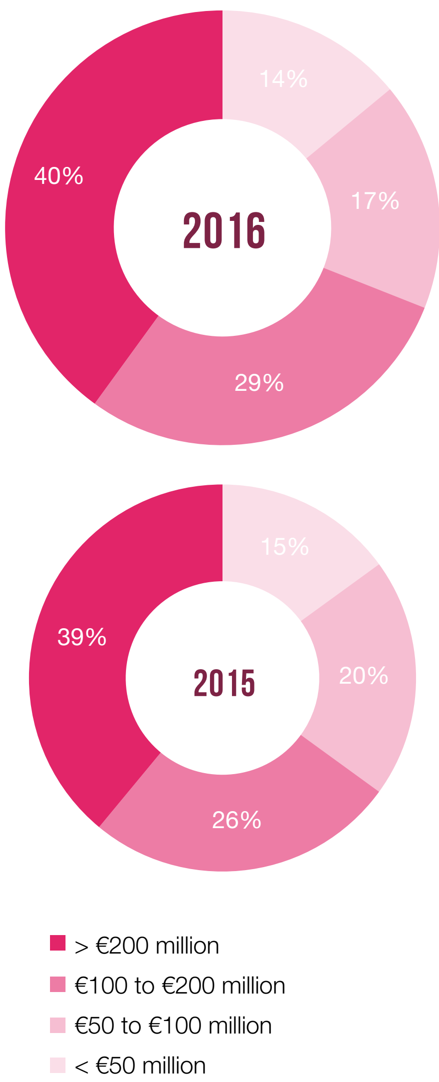
Breakdown of investment activity in the Paris Region by asset class

Source: Knight Frank



Breakdown of investment activity in the Paris Region by transaction amount

Source: Knight Frank



Sweetened condensed milk

The investment market was very lucrative in 2016. However, the concentration of investment volumes in a few large deals also accentuated divergence within the Paris region. It was a sweet year indeed, but sweetened with condensed milk!

Who was the biggest winner in 2016? It was indisputably the Paris Central Business District. Since it offered the most core assets, it attracted almost €5.6bn in investment during the year, representing 33% of the Paris Region's market (excluding regional portfolios). This was a 48% increase compared with 2015, when it only accounted for 22% of investments in the Paris Region. The CBD clearly benefited from the increase in sale prices observed for core assets and purchasers' ability to position themselves on very large unitary amounts.

La Défense was the other market to fare well in this context. With almost €2bn of investment, it remains below the level achieved by the CBD, but made significant progress year-on-year, achieving an increase of 30%.

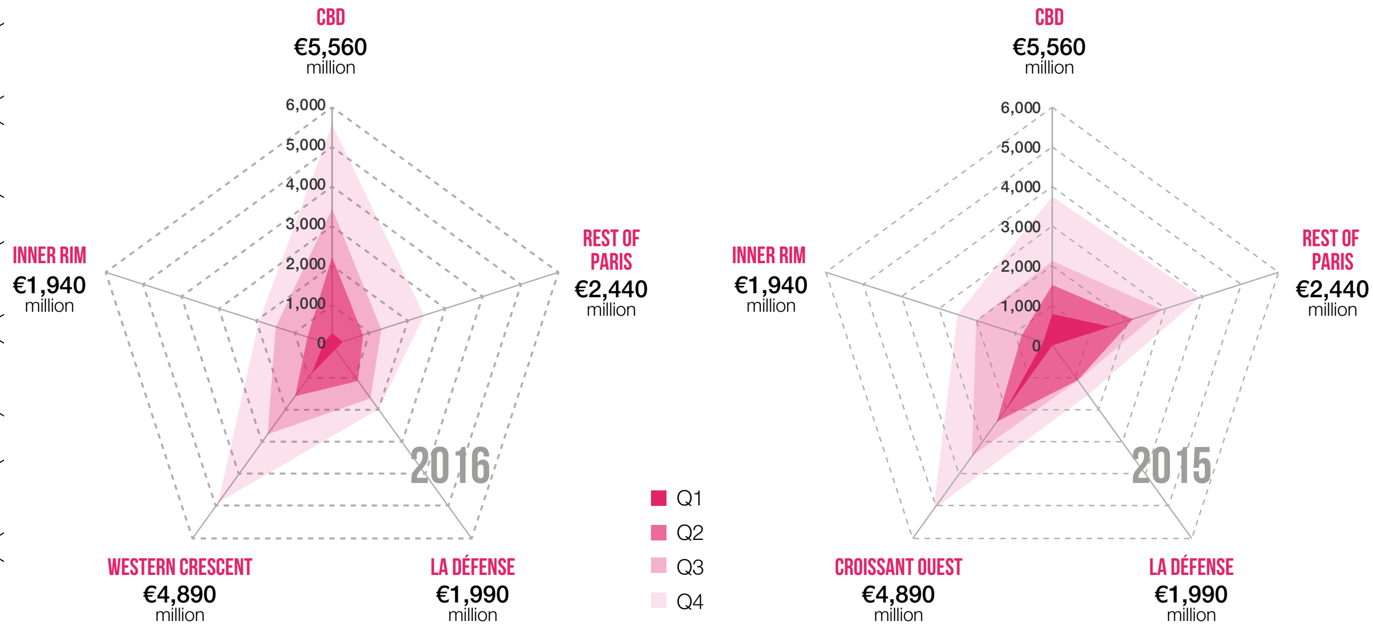
"The biggest winners of 2016 were indisputably the CBD and, to a lesser extent, La Défense. The success of other markets was much more relative."

Other Paris region markets were in much weaker positions at the end of 2016. They offered less available supply. However, the contraction in yields observed in some transactions reinforces their potential appeal.

The Western Crescent suffered less, retaining a 29% share of the regional market and recording a fall of only 4% in investment volumes. This performance is not too bad considering that the Western Crescent recorded an exceptional year in 2015, with a doubling in the level of investment activity. It benefited in 2016 from investors' attraction to areas including Levallois-Perret, Neuilly and Rueil-Malmaison, which are well known as established tertiary centres. The usual powerhouses – Boulogne-Billancourt

Geographical and quarterly breakdown of investments in the Greater Paris Region in 2016

Source: Knight Frank



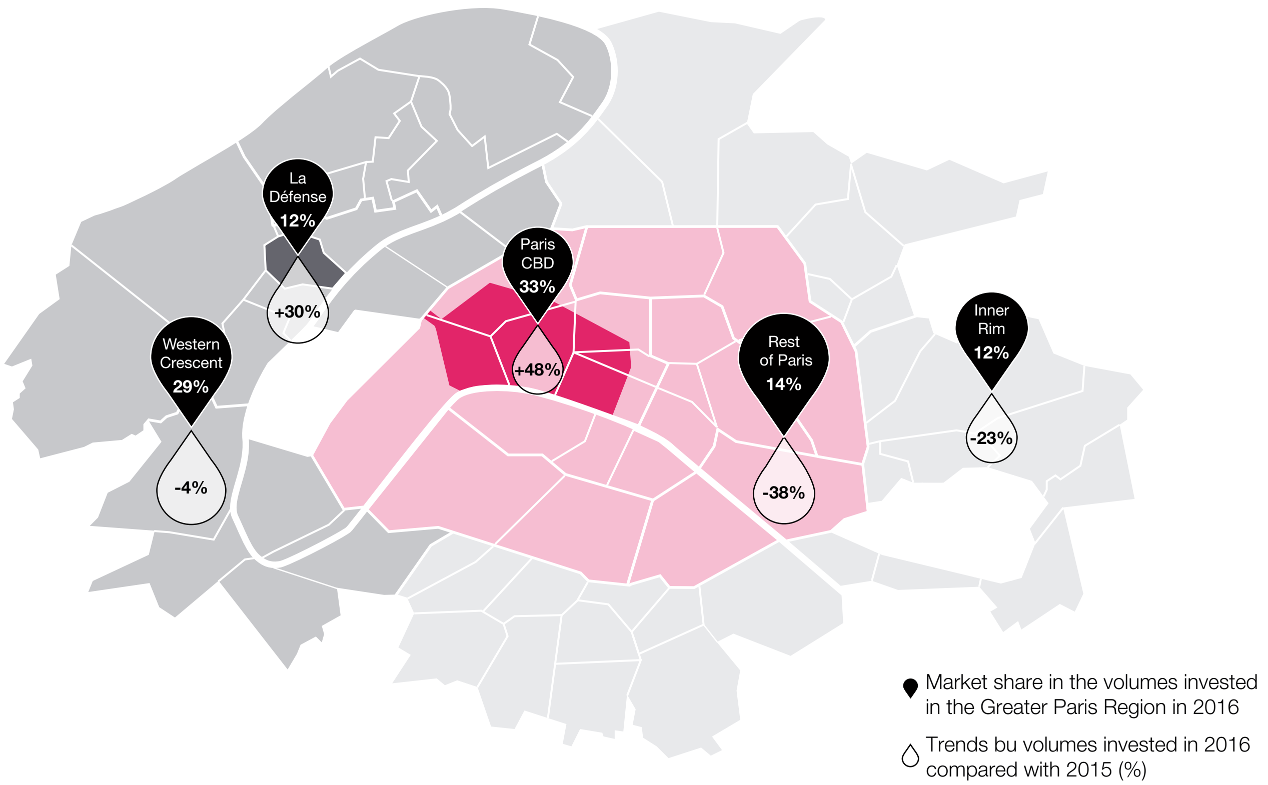
and Issy-les-Moulineaux – were slightly left behind, however. Many assets there had already been subject to arbitrage the previous year.

The decline was much more severe elsewhere. A fall of 23% was recorded for the Inner Rim and up to 38% for inner-city Paris excluding the CBD. It's not that those areas suddenly became abhorrent to investors, but since they cannot offer the same number of opportunities as the CBD, La Défense or the Western Crescent, there was a lack of opportunities. When an opportunity arises, it is quickly snapped up, as demonstrated by the acquisition of Le Ponant (15th arrondissement) by Icade for €202m, and off-plan sales including the acquisition of 25,700 sq m in Ora (17th arrondissement) by Amundi and La Macif for almost €180m, and of 24,800 sq m in the Les Mariniers development (14th arrondissement) by Tishman Speyer.

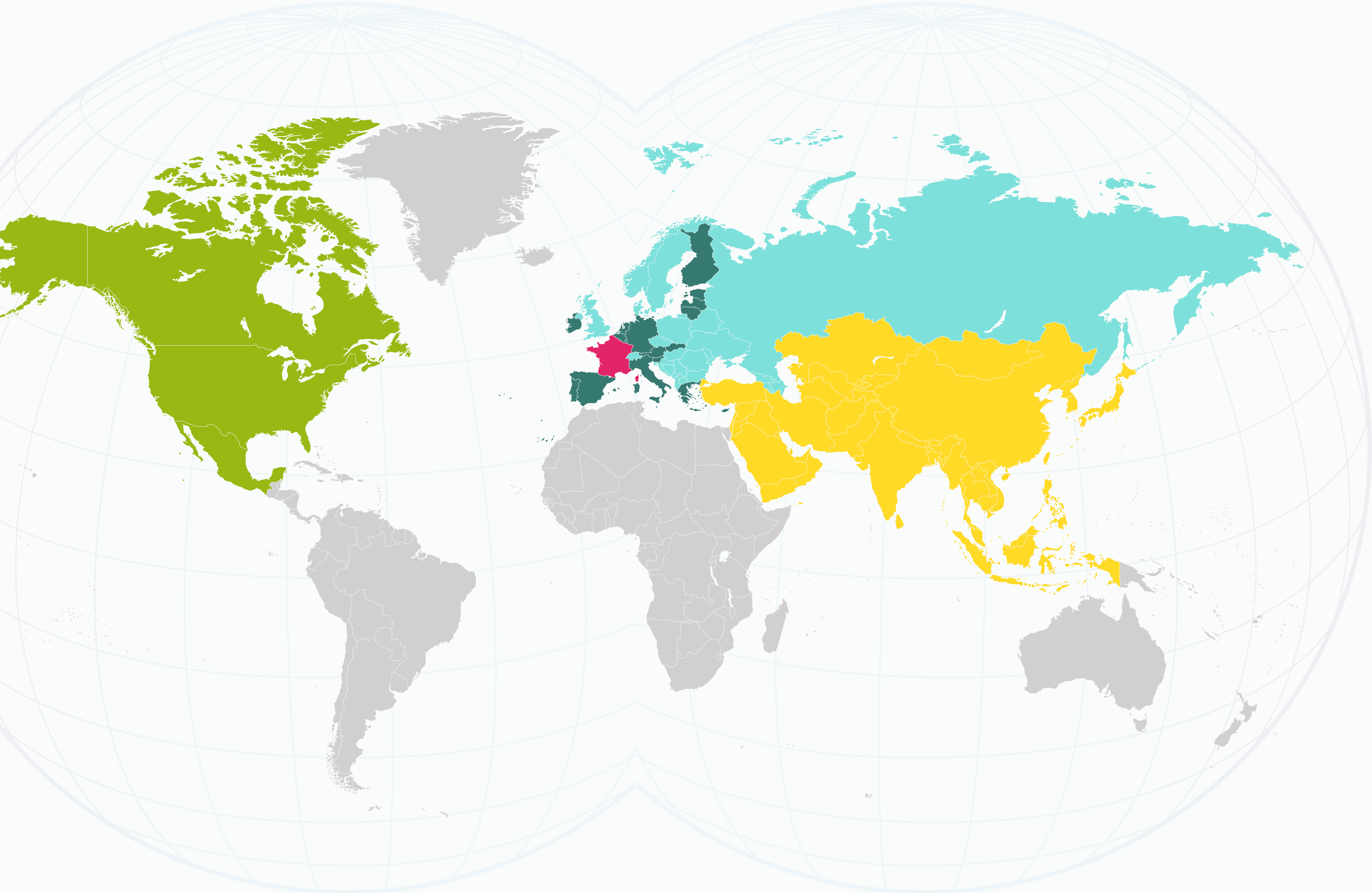
However, these opportunities were too few and far between. The market remained barren. There's nothing like a little market concentration to make things interesting.

Location of investment activity in 2016 and comparison of changes in different markets

Source: Knight Frank



SOURCE OF FUNDS INVESTED IN THE PARIS REGION



FRANCE

Volume invested: €13.29 billion

Market share in acquisition:

2016 68%

2015 62%

EUROPE OUTSIDE EUROZONE

Volume invested: €1.85 billion

Market share in acquisition:

2016 10%

2015 8%

NORTH AMERICA

Volume invested: €1.46 billion

Market share in acquisition:

2016 7%

2015 13%

EUROZONE

Volume invested: €0.99 billion

Market share in acquisition:

2016 5%

2015 3%

ASIA/MIDDLE EAST

Volume invested: €1.44 billion

Market share in acquisition:

2016 7%

2015 7%

OTHERS

Volume invested: €0.51 billion

Market share in acquisition:

2016 3%

2015 7%

#02 - PURCHASERS

Local speciality

Markets are like local culinary specialities.

They may be internationally acclaimed and arouse curiosity and interest, but mastering them is not so simple. Not that it is forbidden to try, but such mastery requires presence, in-depth knowledge, perseverance and investment, which do not come easily.

This was demonstrated on the Parisian market again in 2016. It largely became a local speciality once more.

Once more? Yes, because it was not always that way. Until the financial and economic crisis of 2007/2008, the Paris market was one of the most open to international investment flows. In fact, until then many French investors had spurned real estate and those who did show an interest had not adopted the methods and techniques imported by international specialists in the sector since the 1990s – methods and techniques which largely transformed real estate into a financial asset. This proved very profitable for major European and global investors on the Parisian market.

"French investors invested more than €13bn during 2016, representing the lion's share with 63% of funds invested in corporate real estate in the Paris Region."

French stakeholders have caught up since then, to say the least. Driven by stricter standards and prudential rules and the size of the funds they had to invest, and encouraged by the performances achieved in corporate real estate, they showed renewed interest in that asset class. Their return proved beneficial all round by focusing on the domestic market.

These domestic investors, including banks and national insurance companies and other collective investment funds dedicated to the French real-estate sector invested €13.3bn in 2016. They therefore took the lion's share, accounting for more than 68% of funds invested in corporate real estate in the Paris Region, a much higher proportion than in 2015 (62%). Axa, for example, acquired the Tour First in La Défense for €800m, while Amundi purchased the pan-European Alpha portfolio, in which the Paris Region (including Tour Egée and the Orsay and Stadium buildings) is estimated to account for €700m.

In second place, European investors from outside the eurozone accounted for 10% of investment volumes. Activity has grown considerably, with their share just 8% in 2015. However, this increase occurred at the very end of the year as the result of a single transaction, namely the acquisition of 9 Place Vendôme by Norges, a Norwegian bank. Despite their appetite being unabated, their market share therefore remains subject to the unpredictability of further deals on that scale.

Asian funds, primarly koreans, could have caught up with or even overtaken them had it not been for the postponement of major transactions. This group of investors 'only' managed to invest €1.4bn in the Paris Region market, maintaining their market share at 7%. They were behind some major deals, including the acquisition of the Novartis Campus in Rueil-Malmaison by Korean Investment Securities (€350m).
Asian and Middle Eastern funds could therefore have made significant progress – but their advance has no doubt simply been put on hold. With a helping hand from Brexit, many of those investors turned to the Parisian market and look set to significantly increase their exposure there.

The eurozone remains close to its low-point, meanwhile, accounting for just 5% of investment volumes in 2016. The Germans, who traditionally dominate this category and a few years ago played a major role on the Parisian market, remain net sellers, continuing with arbitrages as part of the winding-up of some of their funds.

Finally, the North Americans are clearly pulling out, their market share falling from 13% to 7% in 2016. They were penalised by the decline in value added, which constitutes one of their specialities.

Having achieved record inflows and reassured by the solidity of the rental market in the Paris Region, domestic stakeholders positioned themselves on a much wider range of assets than before, thereby ensuring their dominance. Investment in the Paris Region has certainly become a local speciality.

#03 - PRICES AND YIELDS

New sugar wars

The control of sugar, like other commodities, is sufficiently strategic to have actually driven major powers to war. In the 18th century these were referred to as "sugar wars".

Things were done differently in the past. Now we have much more peaceful competitions, in which control over commodities is based more on the financial resources of the various participants. The corporate real-estate investment market is no exception. In this case, the commodity is buildings. Competition between potential buyers to control them grew increasingly fierce over the course of 2016.

The effects of that competition were reflected in acquisition prices. Although average market values only crept up slightly (€13,700/ sq m for offices in the CBD at the end of 2016), market values for prime assets shot up. Again in the CBD they stood at just over €24,600/ sq m for office buildings in Q4 2016 – up 19% year-on-year. If the asset includes a significant share of retail space, then market values really soar, frequently exceeding €30,000/ sq m.

La Défense saw slightly more sensible increases in this category. The market value of a prime office building there increased by "only" 6% to stand at almost €11,500/ sq m in Q4 2016. This difference is obviously due to the disparity between high-end rents compared with the CBD and the fact that La Défense is almost exclusively made up of very large buildings, whose price per sq m is lower than that of smaller assets. Furthermore, La Défense preceded the CBD with a higher increase in market values the previous year.

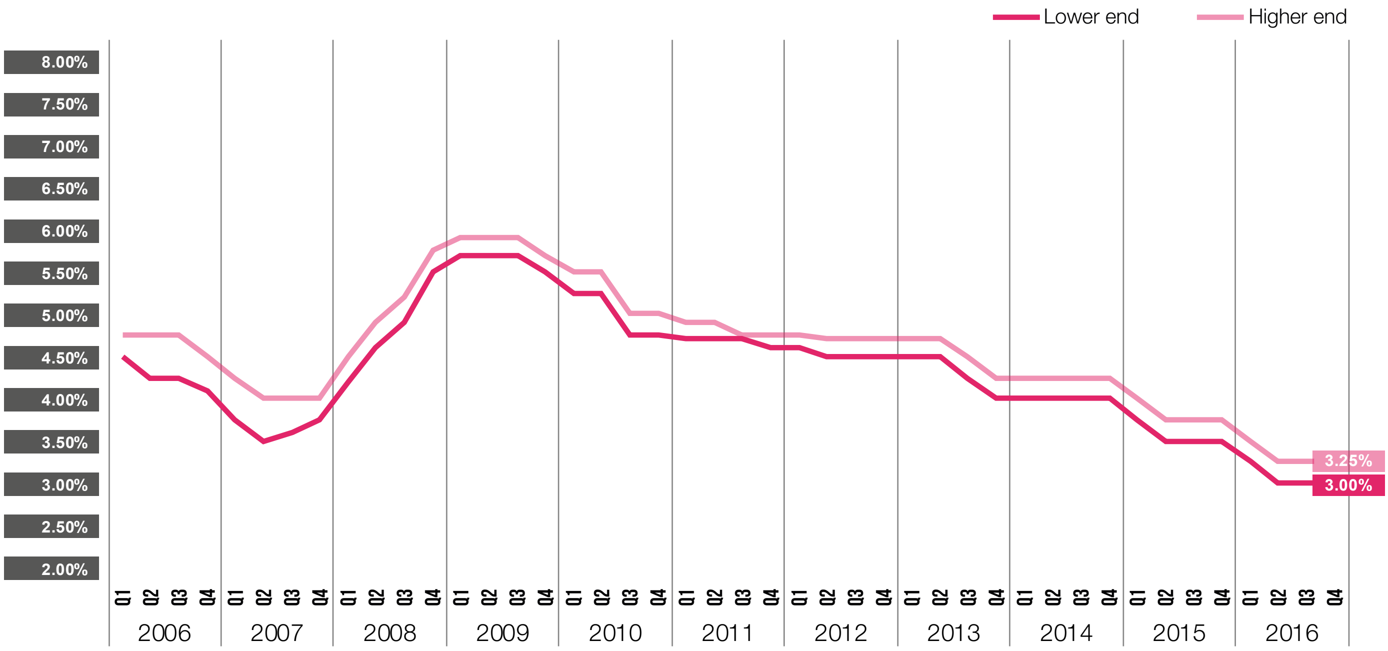
> "At €24,600/ sq m, the market value of a prime office building in the CBD grew by 19% year-on-year, due to the compression in rates. The €30,000/ sq m mark is regularly exceeded for properties with a significant share of retail space."

Along with the increase in prices, there has also been a fall in yields. For the best assets in the CBD and La Défense, prime yields fell 50 base points during 2016. This marks the continuation at exactly the same pace of the trend observed during 2015

> "For the best assets in the CBD and La Défense, prime yields fell 50 base points in 2016."

In December 2016, prime yields stood at between 3% and 3.25%, a level we consider to correspond to a core asset of "traditional" offices. Lower rates, of less than 3%, have occasionally been observed in a few trophy properties and for properties including a high proportion of retail space, although this should not be considered representative.

Change in prime yields in the Paris Central Business District
Source: Knight Frank



With yields at that level, the market has fallen below the low point observed before the financial crisis broke in 2007/2008. Never have prime yields been weaker.

Never have prime yields been weaker in Ile-de-France." However, the spread guaranteed by real-estate assets remains satisfactory compared with other forms of investment."

Does this mean that competition is driving purchasers to act foolishly? No. The best buildings may never have sold for so much, but those buildings are now just assets like any other, on a par with equities and bonds, and it is certainly true that the yield from a core building is much higher. Despite the rise in bond rates at the end of 2016, the spread compared with 10-year bond yields remains significant, although it is narrowing. Real estate gave a 238 base point advantage over the TEC 10 index in December 2016. That spread is narrower than the difference recorded at the end of 2014 (317 points) and even the end of 2015 (271 points) but remains well above the 10-year average (194 base points). On occasion, the spread has even been negative, particularly in 2007 during the previous low point in real estate yields.

Another major difference compared with 2007 is that rents were then at the top of their cycle, which is not the case today. We should remember, however, that the yields reported at the time of acquisition are initial rates. After many years of adjustments and even reduction in rents, many owners are now expecting a medium-term revaluation of their asset's rental income and therefore an increase in the yields provided. It is a gamble, but it does not appear unreasonable, particularly since 2016 saw a slight upward movement in rents for the best buildings.

The contraction in prime yields was more moderate outside the CBD and La Défense, only rarely exceeding 25 base points. It should be added, however, that competition between purchasers was also more limited in those areas, due to a lack of opportunities. They lacked the raw materials.

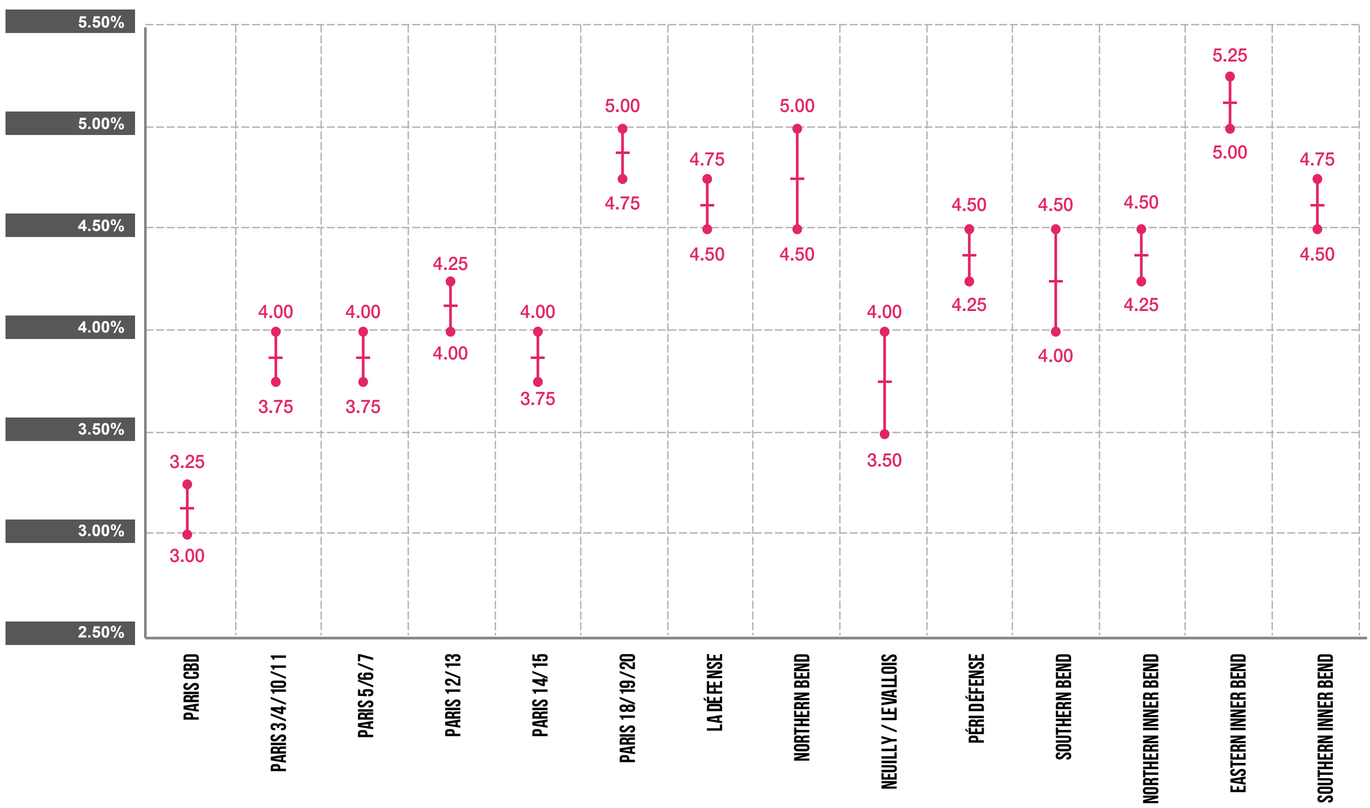
This lack of supply could drive purchasers to seek alternatives. To return to our comparison with the sugar wars, it was due to the lack of guaranteed sugar cane supplies that the sugar beet industry developed. Similarly, the shortage of core assets led some investors to seek opportunities elsewhere, in various niche markets or by turning to buildings for refurbishment or development.

"Value-added yields generally offer an additional premium of 200 to 350 base points compared with prime yields."

It is therefore difficult to identify a trend in yields, since situations vary from one development to the next depending

Range of prime yields by geographical area

Source: Knight Frank



on stakeholders. Nevertheless, value-added yields generally offer an additional premium of 200 to 350 base points compared with core assets. For example, the Vinci head office in Rueil-Malmaison, which may be vacated in the medium term, was sold on the basis of a 7.80% yield, 330 base points higher than the top of the range of prime yields in the sector. The same is true of Be Issy, under development in Issy-les-Moulineaux, which was sold at a rate of almost 7%, representing a discounted yield of 250 base points higher than that for a core building in the Southern Bend (4% to 4.5%).

The yields observed for value-added assets also fell over the course of 2016, without any significant narrowing in their spread compared with prime yields.

Competition between purchasers did not lead to any confusion between sugar cane and sugar beet… The market isn't mad.

OUTLOOK

With market values at a high-point peak and yields at a low point, we are already hearing murmurings about hysteria and familiar warnings of a bubble.

The market is a little like an overheated oven, spoiling the browning cake. In that case, market players are greedy cooks who have certainly had enough.

Absorption?

Eating a lot of sugar, cream and chocolate often makes you feel full. Moderation is then required and it is natural to want to find simpler and lighter pleasures.

The corporate real-estate investment market is not immune to this effect. Uncertainty exists. However, no-one knows what 2017 will bring.

It is certainly very likely that the environment will be slightly less favourable for the investment market in 2017 than it has been over the last two years. Competition from alternative investments may increase for real estate. It would therefore be reasonable not to expect transaction volumes to remain at such high levels or yields to continue falling so steadily. Is that enough to bring on indigestion or even consider a diet? Probably not, particularly since the real-estate sector could benefit from more favourable factors. It would be better to talk of absorption.

INVESTMENT VOLUMES AND BUYERS

Uncertainty in 2017 stems above all from the potential for equity or bond investments to become more attractive, having burnt some investors' fingers in recent years. Either too much risk or not enough profitability – take your pick. In any case, real estate – particularly in the Paris region – appeared to provide a safe haven combining comparative security and yields and offering an alternative to investment funds.

Improvement in the appeal of competing investments?

> "French bond yields rose sharply in 2016. This is likely to continue, though remain moderate."

In terms of government bonds, 2016 ended with a significant recovery. Yields from 10-year French bondson the secondary market stood at 0.7% at the end ofthe year, up from 0.1% at the start of August. It was not so much the scale of this recovery which proved surprising, but its speed. Having been triggered by an inflationary outlook created by rising commodity prices, it was then accelerated following announcements of infrastructure expenditure by Donald Trump and his protectionist leanings, meaning that the increase occurred in less than two months.

If this is a long-term trend, then bond investments could once again become attractive to investors. Is that the case? Bond rates are set to continue to rise. But no major transformations are likely. This is firstly because the movement observed at the end of 2016 corresponds to a return, albeit very rapidly, to the levels observed less than a year before and marks the end of a historically unusual period, characterised by zero-remuneration for lenders. Secondly, because there is every indication that the recovery will now be slower and on a more limited scale. The European Central Bank will reduce its debt purchasing from March 2017, pushing up bond rates, although it will remain very wary of causing any destabilisation. It has therefore set a very cautious timetable. Overall, Agence France Trésor, the agency responsible for investing French debt, anticipates a 10-year rate of 1.25% by the end of 2017, equivalent to the rate in place at the end of October 2014.

In terms of equities, 2016 ended with stock market euphoria. In New York, the Dow Jones index took off in mid-December, approaching the 20,000-point mark, while in London the FTSE gained almost 1,200 points during the second half of the year. In emerging countries, the São Paulo stock exchange gained 40% while the Moscow stock exchange racked up a 25% rise. Only in the eurozone, bogged down in political uncertainty and modest growth, was the movement less pronounced.

"A wind of optimism is blowing through stock markets. The hopes on which it is based now need to be realised since valuations now look to be high."

Stock markets demonstrated an astonishing capacity to absorb numerous shocks and political upheavals to ultimately peg themselves to prospects of improved global growth. They particularly adopted a "value" approach, favouring discounted shares with prices likely to benefit from renewed growth.

Will this dynamic continue into 2017, channelling monetary flows towards stock markets? Many hope so. But as well as the many potential disruptions, with forthcoming elections in France and Germany, the start of Brexit negotiations and questions over Chinese debt, it will all ultimately depend on listed companies' capacity to improve their results. If they do not, irrespective of whether or not global growth picks up, the dynamism of recent months will have been based on dashed hopes. However, many analysts already consider stock market valuations to be high in America and on several global stock markets.

It is therefore possible that stock market volatility will increase in 2017, following the rapidly absorbed spikes seen in 2016 after the surprises of the British and Italian referendums and the US elections. This climate of instability is generally favourable to the real-estate sector, which offers tangible underlying assets. Investors therefore have little reason to abandon it to any significant extent, particularly since their exposure remains limited. For example, a recent survey by the International Forum of Sovereign Wealth Funds indicates that although real estate and infrastructure represent 8% of sovereign funds' investments, equities account for 34% and bonds 53%[2].

There could therefore be fiercer competition, but also greater instability and, ultimately, much uncertainty — too much to be able to predict a precise amount of investment in Parisian real estate by the end of 2017. It will certainly not be easy to remain at such high levels as those seen in 2015 and 2016, but while a fall is likely, it will probably be modest. No, there does not appear to be a risk of indigestion in 2017.

YIELD

Will the contraction in yields ever end? A year ago, it was generally agreed that this would occur in the second half of 2016. Stabilisation was predicted, based on historic comparisons and prospects of a rise in bond rates following the tightening in US monetary policy initiated by Janet Yellen at the end of 2015. But then, to everyone's surprise, bond rates suddenly collapsed, paving the way for the continued decline in prime real-estate yields, while ensuring they continued to offer a significant comparative advantage.

The environment looks very different as we enter 2017. The rise in bond rates is no longer a prediction – it is well under way and is set to continue, although gradually and modestly. The spread between bond yield and real-estate yield has begun to narrow, shedding 33 base points in a year. All these factors look set to encourage a gradual stabilisation in real-estate yields.

"Gradual stabilisation in prime yields is the most likely scenario in 2017, meaning that there is still some room for downward movement."

This will be gradual since there remain some issues to be resolved. Although the spread with bond yields has narrowed, it still remains high, at 44 base points above the 10-year average (238 points at the end of 2016 compared with 194 points over 10 years). It is therefore possible that there will be a further fall in rates in the next few months for transactions relating to the very best real-estate assets.

However, these falls are likely to be limited to a small number of transactions and modest in size. In fact, based on the assumptions adopted by Agence France Trésor for returns on French government bonds (1.25% at the end of 2017), the spread between bond yields and real-estate yields (on a like-for-like basis for the latter) will fall slightly below the 10-year average before the end of the coming year. There is nothing alarming in that, since the market is well able to absorb a contraction in the spread, resulting in levels previously recorded between 2011 and 2013, so this will not necessarily represent a turning point in real-estate yields.

Stabilisation therefore certainly looks likely to be gradual, while a future rise is still some way off.

[2] Les Echos, 27 December 2016

QUESTIONS FOR

LOUIS-SIMON FERLAND

Managing Director
Blackstone

> FRANCE IS AND HAS ALWAYS BEEN A STRATEGIC MARKET FOR BLACKSTONE. WE HAVE BEEN INVESTING IN THE COUNTRY SINCE 1997.

Knight Frank: Blackstone is very active in many international markets, which gives a good overall view. Is Paris different from other places in Europe or around the world and what are its possible strengths and weaknesses?

Louis-Simon Ferland: As you know, Paris is the largest office market in Europe, and amongst Europe's most liquid investment markets. The market attracts meaningful amounts of both domestic and international capital, and has a well-established REIT sector which includes some of Europe's largest, highest-quality, and most well-known public companies such as Unibail-Rodamco, Klepierre, Gecina, and several others. In addition, its financing market is deep and diversified, supported by a strong domestic banking system. These are all clearly key strengths, which outweigh, from our perspective, the negatives. Weaknesses, as we see it, would include the current low-growth domestic economy and a regulatory environment that makes it more challenging to invest in certain sectors such as residential and senior living, for example.

KF: The investment market in Ile-de-France saw strong growth in 2016, with very high volumes of activity, a lack of offers to sell and yields that reached a historic low. In such a context, what are the opportunities for a fund like Blackstone?

L-S F: France is and has always been a strategic market for Blackstone. We have been investing in the country since 1997 and, supported by our portfolio companies and local operating partners, continually review investment opportunities for our different funds. In the current environment we focus on opportunities that play to our strengths, such as larger, complex and time sensitive situations where sellers seek certainty and a reliable counterparty. We are also becoming increasingly active throughout Europe in our Core+ business, which has now reached $14 billion of AUM globally.

KF: Given the lack of opportunities to acquire and reduced yields, investors are exploring new avenues and looking for real estate alternatives. Do you see emerging trends or asset categories emerging from traditional models?

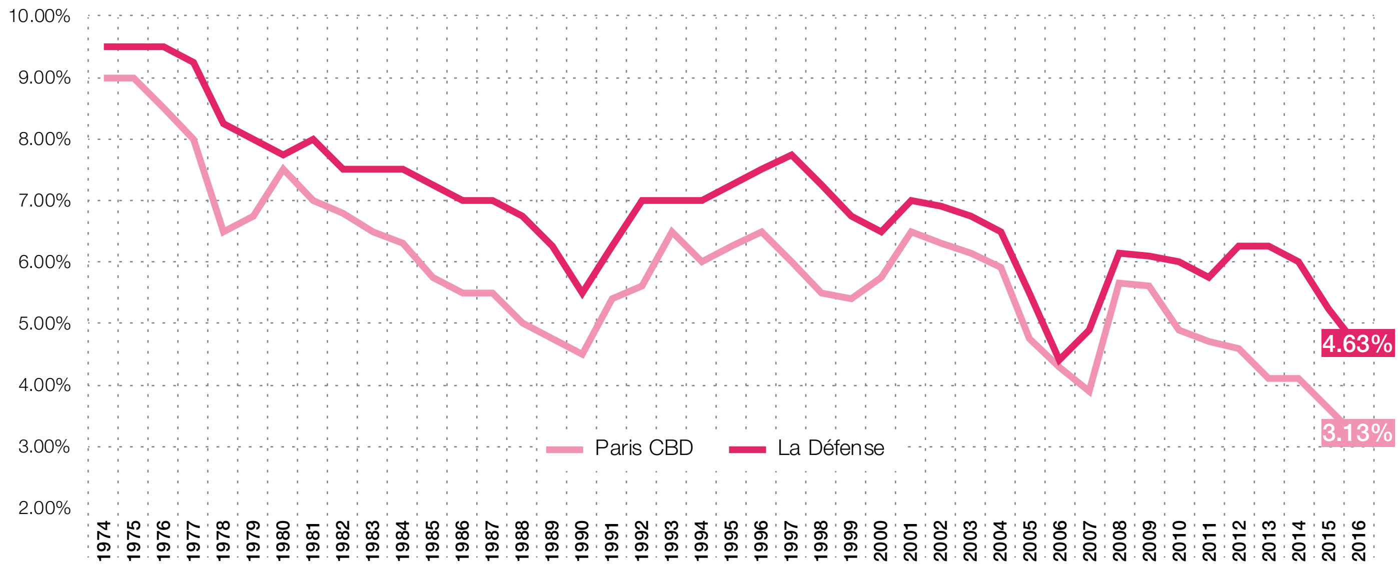
L-S F: We see the reconfiguration of the retail supply chain, driven by e-commerce, as a long-term trend providing significant tail winds for logistics real estate. As such, we have been active investors in logistics in Europe since 2012 and have created Logicor, the largest direct owner of logistics assets in Europe. Our logistics portfolio in France, by way of example, is currently nearly three million SQMs.

Given demographic trends, continued urbanization, and the growth of innovation-focused cities in particular, we also see residential and senior housing as benefiting from favorable tail winds.

FLASHBACK

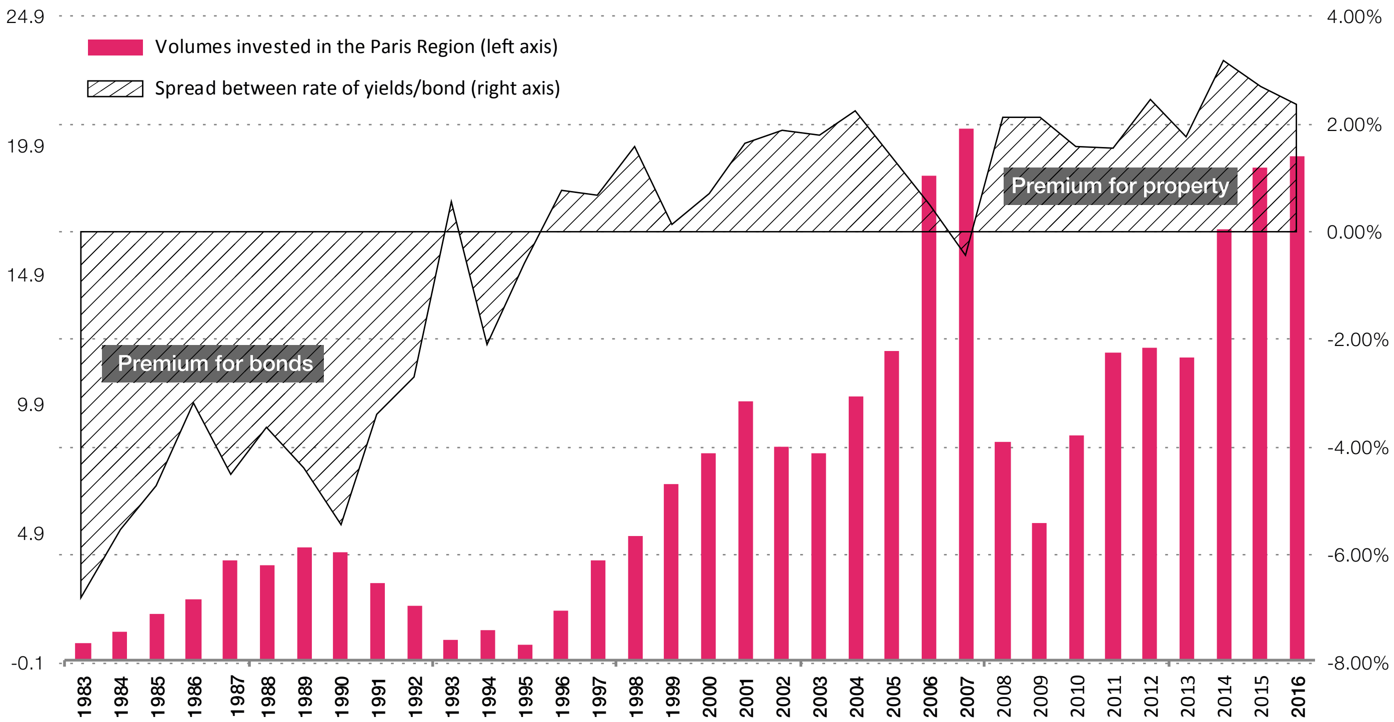
Trends in prime yields since 1974 (in%)

Source: Knight Frank



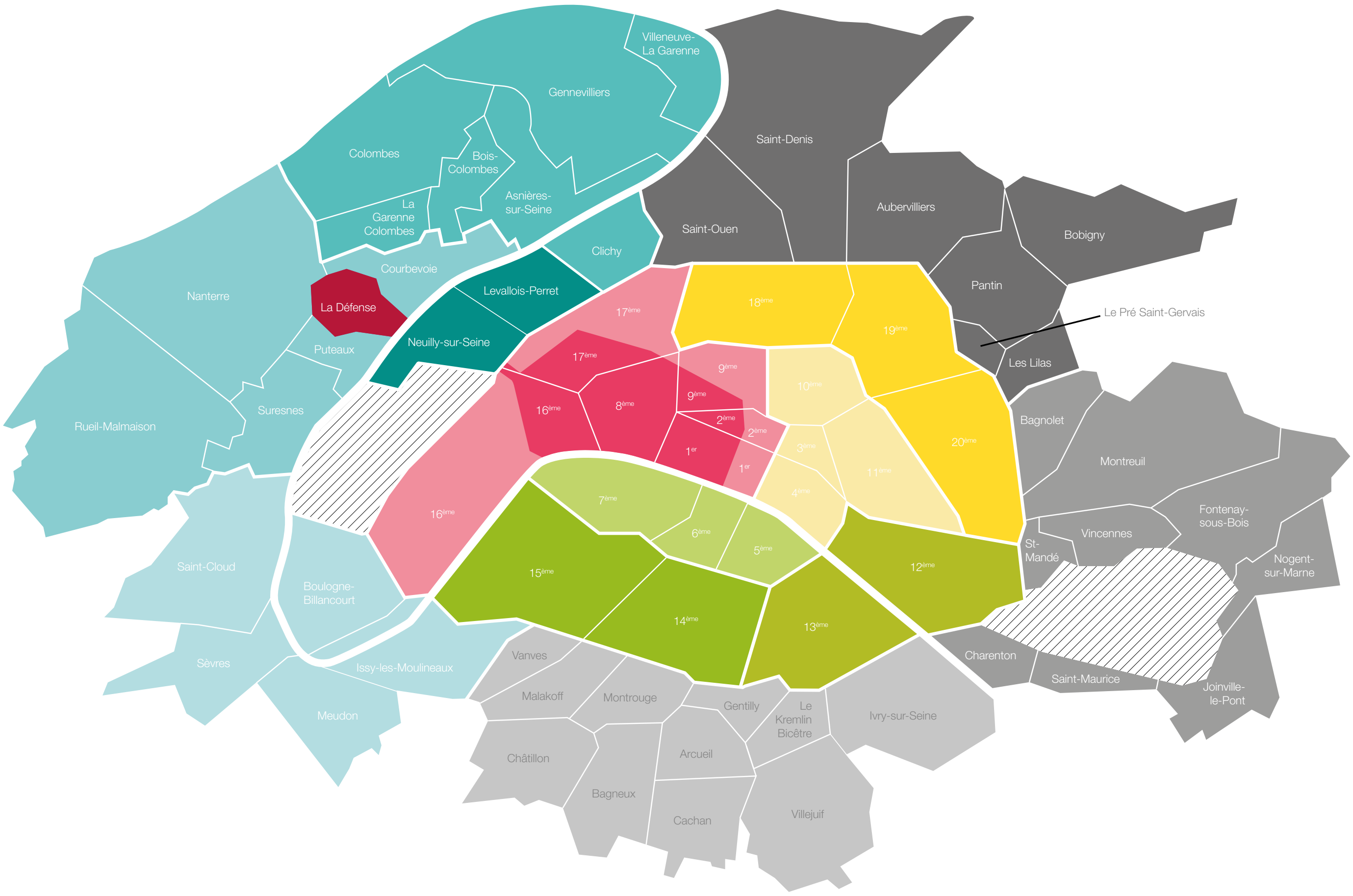
Investment volumes in the Paris Region and compararative spread between yields and bonds

Sources: Knight Frank, CDC - Comité de normalisation obligataire



Nota: Le taux de rendement correspond au taux de rendement Prime (valeur intermédiaire de la fourchette) sur le QCA.
Le placement obligataire correspond à l'OAT TME de 1983 à 1995 puis TEC 10 à partir de 1996.

2016 KEY FIGURES



Paris CBD	Paris 3/4/10/11
Paris Centre West (excl. CBD)	Paris 18/19/20
Paris 5/6/7	La Défense
Paris 12/13	Northern Bend
Paris 14/15	Neuilly/Levallois
Péri-Défense	Southern Bend
Northern Inner Rim	Eastern Inner Rim
Southern Inner Rim	

Area	Volume invested in a year		Prime yields Q4 2016 (range)		High end market value (*) Q4 2016	
	Volume (in €)	Evolution 2016/2015 (**)	Range of rates (in %)	Evolution 2016/2015	(€/m²)	Evolution 2016/2015 (**)
Paris CBD	**5,562,205,000**	↗	**3.00 / 3.25**	↘	**24,640**	↗
Paris Centre West (excl. CBD)	**647,930,000**	↘	**3.25 / 3.50**	↘	**19,260**	↗
Southern Paris						
Southern Paris / Paris 5/6/7	293,120,000	↗	3.75 / 4.00	→	Non significatif	
Southern Paris / Paris 12/13	242,620,000	↘	3.75 / 4.25	→	13,750	↗
Southern Paris / Paris 14/15	970,875,000	↗	3.75 / 4.00		13,675	↗
Total Southern Paris	**1,506,615,000**	↘				
North Eastern Paris						
North Eastern Paris / Paris 3/4/10/11	242,035,000	↘	3.75 / 4.00	↘	13,420	↗
North Eastern Paris / Paris 18/19/20	32,775,000	↘	4.75 / 5.00	↘	7,590	↗
Total North Eastern Paris	**274,810,000**	↘				
Total Paris intra-muros	7,991,560,000	↗				
La Défense	**1,987,200,000**	↗	**4.50 / 4.75**	↘	**11,460**	↗
Western Crescent						
Western Crescent / Northern Bend	107,880,000	↘	4.50 / 5.00	↘	7,370	↗
Western Crescent / Neuilly Levallois	1,406,850,000	↗	3.50 / 4.00	↘	13,865	↗
Western Crescent / Péri-Défense	2,039,280,000	↗	4.25 / 4.50	↘	9,370	↗
Western Crescent / Southern Bend	1,331,975,000	↘	4.00 / 4.50	↘	11,295	→
Total Western Crescent	**4,885,985,000**	↘				
Inner Rim						
Inner Rim / Northern Inner Rim	1,083,000,000	↗	4.25 /4.50	↘	7,655	↗
Inner Rim / Eastern Inner Rim	413,060,000	↘	5.00 / 5.25	↘	6,245	↗
Inner Rim / Southern Inner Rim	441,985,000	↘	4.50 / 4.75	↘	7,245	→
Total Inner Rim	**1,938,045,000**	↘				
Outer Rim	**892,260,000**	↗	/	↗		
Paris Region Portfolios	1,845,135,000	↗	/	↗		
Total Paris Region	19,540,185,000	↗		↗		

Source : Knight Frank
(*) : Representative high end market value, calculated from the high end rent held for each geographical sector and the Prime rate of return
(**) : The volume invested and the market value are considered to be stable, while their annual evolution, both upwards or downwards, is between -2% and 2%

KNIGHT FRANK

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