The French investment market
Q1 2020

Covid-19
What is the outlook for the French investment market?

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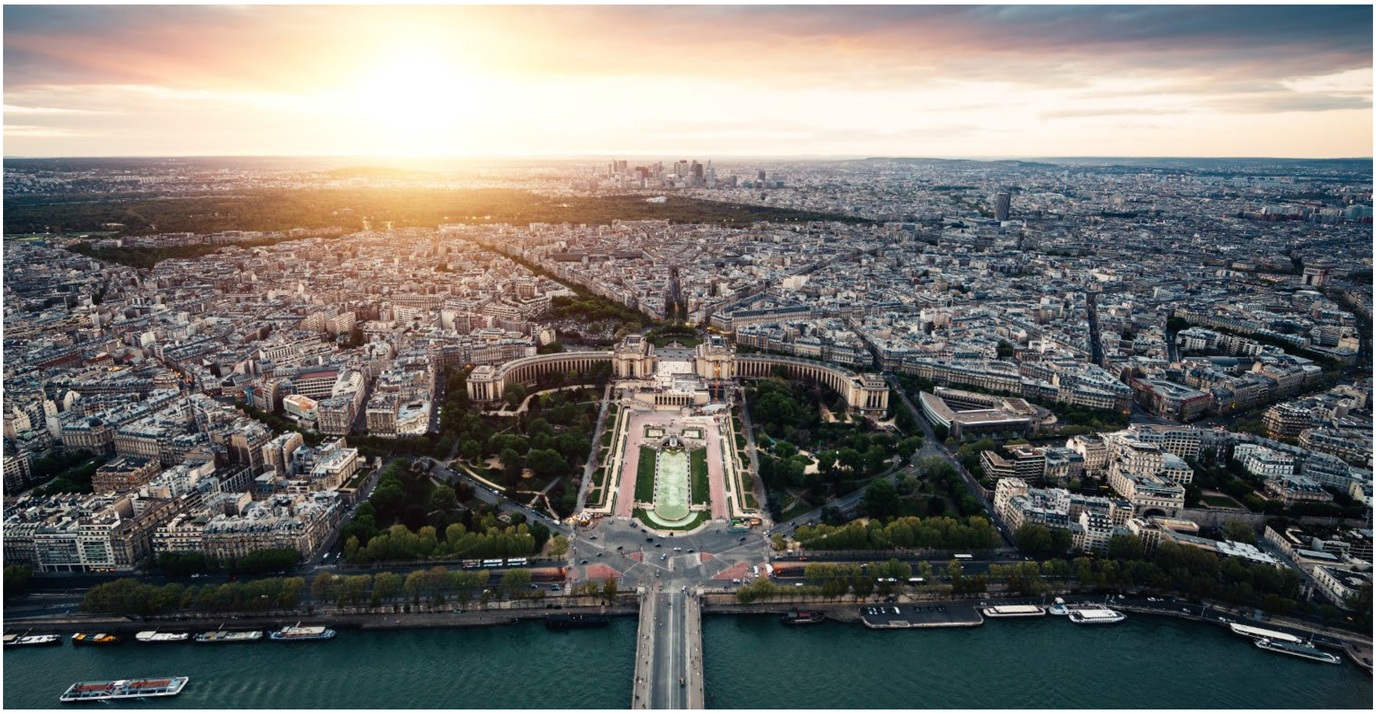
COVID-19

WHAT IS THE OUTLOOK FOR THE FRENCH INVESTMENT MARKET ?

At the beginning of 2020, the excellent momentum of the French investment market seemed set to continue despite the economic slowdown and geopolitical tensions. After a record year in 2019 (37.6 billion euros invested), forecasts were for volumes close to 30 billion euros, once again well above the ten-year average (23.2 billion).

In the 1st quarter 2020, the trend remained very positive, with a significant 28% increase in investment volumes compared to the 1st quarter 2019. However, the spread of the coronavirus has changed the game. Consequently, the implementation of severe restrictions will necessarily weigh on activity in 2020, even if it is very difficult to estimate the extent of the slowdown until we know how long the lockdown period will last.

Covid-19 could also have consequences in the longer term, which Knight Frank analyses in this first update since the outbreak of the health crisis.



THE FRENCH INVESTMENT MARKET

REVIEW OF 1ST QUARTER 2020

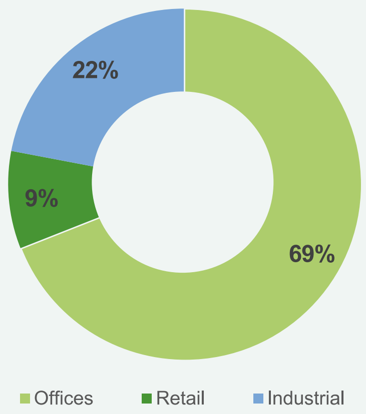
€6.2 billion was invested in the French commercial property market in Q1 2020, a 28% increase year-on-year and 93% higher than the ten-year average. This is the **third best quarter on record after 2006 and 2007.** This very good result was a continuation of an exceptional year-end 2019. €15.6 billion was invested in Q4, resulting in the French market breaking its record for 2019 as a whole. The sums committed in Q1 2020 could have been even higher if the implementation of restrictive measures had not severely curbed activity as of mid-March.

Before the outbreak of the health crisis, activity was more or less the same as last year. Large transactions continued to play a leading role, with **16 transactions in excess of 100 million euros totalling €3.9 billion (63% of total volumes invested).**

13 of these large transactions were completed in the Greater Paris Region. All volume categories taken together, €4.4 billion were invested in Q12020 in the Greater Paris Region, an increase of 41% year-on-year.

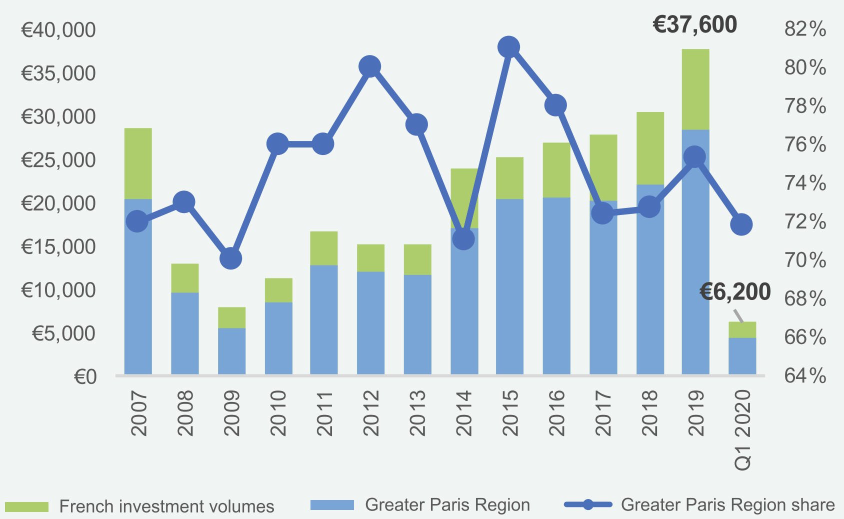
In Q1 2020, the trend was also positive in the French office market. **With €4.3 billion, the increase was 35% year-on-year and 100% compared to the ten-year average**; once again, large transactions played a decisive role, with 13 transactions in excess of 100 million euros accounting for 64% of the total amount invested in offices in France. **Several of these large transactions were undertaken in the capital**, including the acquisitions of 14 rue Bergère by LIM and 50 rue d'Anjou by Aviva Investors. All amount categories taken together, nearly 2 billion euros were invested in offices in inner Paris, a sharp 111% increase compared to Q4 2019.

Breakdown of French investment volumes, by asset type
(as at Q1 2020, as a %)



Source: Knight Frank

French investment volumes, all asset categories*
In millions of euros



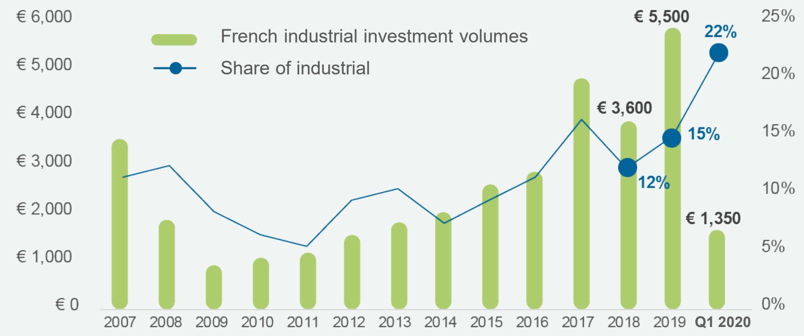
Source: Knight Frank /*Offices, retail, industrial.

In the Western Crescent, activity held up well, even though 40% of the volumes invested in this sector in Q1 2020 (approximately €1 billion) were generated by **one large transaction: the sale of Cap Gemini's new offices ("Aquarel")**, inaugurated last year in Issy-les-Moulineaux. In the Inner Suburbs, a few transactions also boosted volumes, such as the sale by Gecina to Primonial Reim of "Valmy" in Montreuil for more than 200 million euros. Following an outstanding year in 2019 – the second best in history after 2007 – the La Défense market meanwhile slowed down. However, several major transactions were well advanced there before the outbreak of the health crisis. **Outside of the Greater Paris Region, activity was most dynamic in Lyon**, with more than €300 million invested in offices and a number of large transactions, including the acquisition by Aviva Investors of "Lugdunum" and the sale of Cegid's headquarters to Kanam.

With more than €1.3 billion invested since January, the industrial real estate market also began 2020 on a strong footing having set a new record in 2019. **This volume, up sharply by 68% year-on-year, accounts for 22% of the total sums invested in France**, all types of assets combined. Furthermore, it is largely comprised of logistics asset transactions, most of which were sold in the form of portfolios (sale of the “Hub & Flow” portfolio to Ivanhoe Cambridge, acquisition by Patrizia of a pan-European portfolio, etc.). Investors' enthusiasm for logistics also translates into increased risk-taking, as illustrated by Invesco's acquisition of two warehouses to be developed speculatively near Orleans and Reims.

Following a good year in 2019, the retail market got off to a more timid start, with **this asset class posting a sharp 33% year-on-year decrease**. Retail investment volumes were significantly boosted by Mata Capital's acquisition of the “CIFA Fashion Business Centre” in Aubervilliers, Europe's largest ready-to-wear wholesale centre.

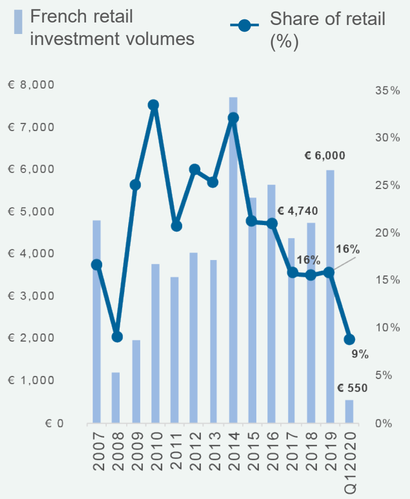
Investment volumes in industrial property in France
In millions of euros



Source : Knight Frank

Other significant retail transactions drove activity, including the sale of five Casino supermarkets to Ascensio for €85 million, and the purchase by a private individual of 56 avenue Montaigne, a mixed-use asset comprising two luxury boutiques. **This transaction accounted for 45% of high street investment volumes, which were down 11% year-on-year.** Finally, the shopping centre market remained virtually flat, even though the beginning of the year was marked by a major event: the formation of a consortium between Crédit Agricole Assurances and La Française to acquire shares in a joint venture involving five shopping centres owned by Unibail-Rodamco-Westfield.

Investment volumes in retail in France
In millions of euros



Source: Knight Frank

Examples of significant transactions in Q1 2020

ASSET	TYPE	SELLER	BUYER	AREA (SQ M)
Mercury Portfolio, France	Logistics	GreenOak	Patrizia	-
14 rue Bergère, Paris 9	Offices	BNP Paribas	LaSalle Investment Management	33,000
Aquarel, Issy-les-Moulineaux	Offices	AXA	DTZ Investors	33,500
Hub & Flow Portfolio	Logistics	Carlyle	Ivanhoé Cambridge	-
CIFA Fashion Center, Aubervilliers	Retail	Eurazeo	Mata Capital	40,000
Le Valmy, Montreuil	Offices	Gecina	Primonial Reim	28,000
50 rue d’Anjou, Paris 8	Offices	Crédit du Nord	Aviva Investors	10,600
79-81 boulevard Haussmann, Paris 8	Offices	Groupe Roullier	Balzac Reim	5,700
Lugdunum, Lyon	Offices	Unofi	Aviva Investors	21,200
22-32 rue de Clignancourt, Paris 18	Offices	BNP Paribas	Vinci Immobilier	11,000

FOCUS ON…

COVID-19 AND ASIA'S INVESTMENT MARKET

Since the Asian continent was hit very early on by the spread of Covid-19, with the first confirmed cases of infection appearing as early as November 2019, it is already possible to measure the effects on the real estate market. Indeed, **the volumes invested in commercial real estate in the Asia-Pacific zone fell sharply by 59% year-on-year in the first quarter of 2020**, totalling US$18.1 billion compared to US$44.2 billion for the same period in 2019. While the downturn was contained in South Korea (-10%), a country that has so far managed to control the pandemic, activity fell sharply in China (-72%) and Hong Kong (-81%), whose market was hit by both the health crisis and political unrest.

Will the Asian market soon recover from the health crisis? Over the past few weeks, **the first signs of recovery have indeed been seen**. In China, whose economy was virtually shut down in February, manufacturing production has resumed, while some hard-hit sectors, such as hotels and tourism, are slowly picking up.

However, as the threat of a second wave emerges, some restrictions have been kept in place, or in some cases re-established, and border controls have been tightened to prevent the entry of new cases. Japan has resolved to declare a state of emergency in the seven prefectures which account for 44% of its population, while Singapore has just initiated a one-month lockdown as it deals with a second wave of infections.

Although caution is still called for in Asia, uncertainty is at its highest level in other parts of the world. Europe and the United States accounted for more than 75% of the total number of officially recorded cases as of 8th April 2020 (compared to only 5% for China), which explains the extension of drastic restrictions that will weigh heavily on their economies. This slump will inevitably affect the performance of the Asian economy. While the WTO recently indicated that world trade could fall by between 13% and 32% in 2020, forecasters agree that China's GDP will contract significantly, growing by no more than 1-2% for the current year after a 6.1% increase in 2019.

The real estate investment market will inevitably suffer from the economic downturn, although **some market sectors will recover faster after the crisis**. This is the case for the residential market, which has already seen a slight recovery. For example, the daily number of sales in China's 30 largest cities at the end of March returned to its early January level, and was even slightly above the December 2019 average by 4%. The recovery is slower in the commercial real estate market. Across all countries, property sales are still constrained by ongoing restrictive measures, and investors are giving **priority to managing their existing assets** to reduce the risk of rental vacancies and maintain the value of their properties. This is especially the case for Korean investors, who had notably driven the French market in 2019, buying €3.4 billion worth of assets in the Paris region, and who, despite some significant transactions (the "Tour des Finances" in Brussels, the OP Financial headquarters in Helsinki, etc.), **have been much more restrained since the beginning of 2020** outside their home market.

In spite of this, some observers are hoping for a fairly rapid recovery of activity in the commercial real estate market, as was the case in the early 2000s in China, Japan and Singapore once the SARS epidemic had been contained. At the beginning of 2020, investors' appetite remains strong, and capital to be invested in Asia, which today totals nearly US$40 billion, is well above the level that existed before the 2008 financial crisis (US$5 billion).

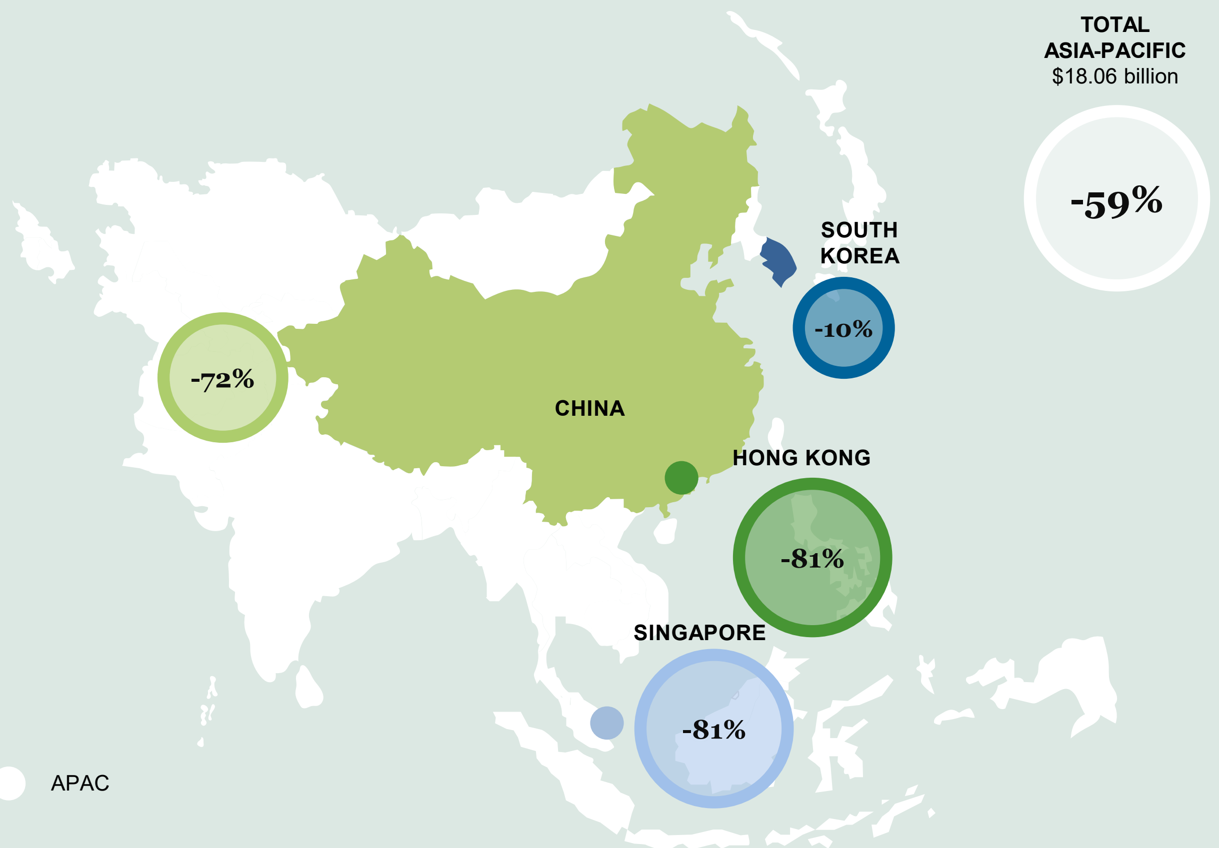
In this context, core assets will be the main target of investors as they are traditionally more resilient to economic shocks. In terms of asset classes, a **premium will be paid in particular in China to logistics warehouses and data centres**, two market segments that were already booming before the health crisis and were boosted by the lockdown period imposed on the population.

In the office sector, **demand will focus on service sector assets in the largest cities**, particularly those that were the least affected by the health crisis, such as Singapore and, in China, Beijing and Shanghai, even though rental activity is still constrained by companies' lack of visibility and the continuation of certain restrictive measures. However, the recovery could be facilitated by a readjustment in the balance of power between tenants and landlords, with the latter being more inclined to revise their rents downwards.

The magnitude of the expected correction in the hotel and shopping centre segment is much greater. Here, indicators remain in the red and the recovery is not yet perceptible. However, opportunistic investors are already on the lookout for opportunities due to the large price drops that have been forecast.

CHANGE IN INVESTMENT VOLUMES IN THE ASIA-PACIFIC REGION Q1 2020 / Q1 2019

Offices, retail, industrial and hotels, as a %



Source: Knight Frank

WHAT IS THE OUTLOOK FOR THE FRENCH INVESTMENT MARKET ?

Before the outbreak of the health crisis, foreign investors were directly contributing to the excellent dynamics of the French market. In 2019, they accounted for 44% of the sums invested in France, a share that rose to 58% in Q1 2020. **Will the presence of foreign investors still be as important in the coming months**? The first indications are fairly positive. Some are completing transactions initiated before the start of the health crisis. Others are already thinking about the future, even if a wait-and-see attitude will prevail as long as market conditions remain uncertain.

French investors will be just as cautious, which will inevitably weigh on the level of investment volumes in 2020. Other, more "practical" constraints will also limit activity (inability to visit properties, slowing down of urban planning procedures, etc.) even if technological advances (remote meetings, electronic signatures, digitisation of sales deeds) partly make it possible to circumvent social distancing measures. Moreover, transactional activity did not quite come to a complete stop with the health crisis. Several transactions have thus been recorded since mid-March.

Others that are sufficiently advanced will be finalised in the second quarter. The first half of the year, nevertheless, is likely to be the weakest in recent years**. It should be remembered that volumes invested in the first half of the year have averaged €10.3 billion over the last five years, compared with €6.2 billion since the beginning of 2020.**

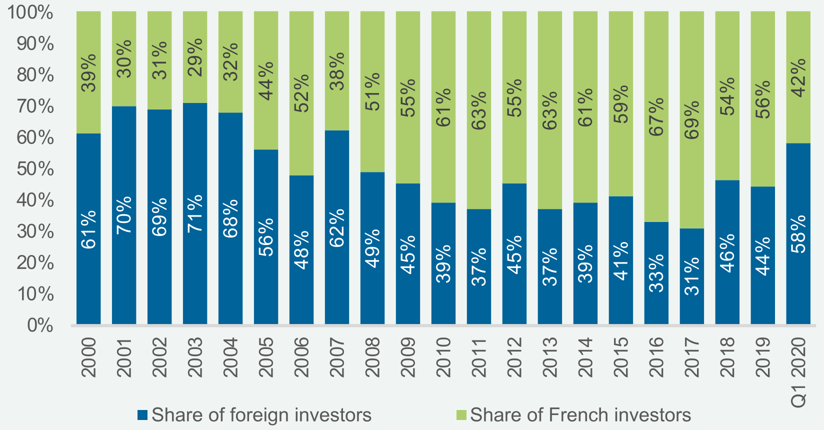
The magnitude of previous crises can, however, give some indication. While the stock market crash of 2001-2002 resulted in a fairly limited decrease in the sums invested in France (-20% between 2001 and 2003), **the financial crisis of 2008 was quite different, with volumes falling fourfold in two years** (from €28.5 billion in 2007 to €7.1 billion in 2009). The downturn was all the more severe as activity had previously set a new historical record after four years of consecutive increases. The Covid-19 crisis also comes at a high point: since 2013, the sums invested have been constantly increasing, rising by 141% to €37.6 billion in 2019.

Can we learn from this for the future? Nothing is less certain. Firstly, because the situation will remain very unclear until we have a clearer picture of the consequences of Covid-19 on the world economy and on the rental markets and, secondly, because this is a health crisis and not a financial crisis.

> **"What usually takes months or quarters to happen in a recession is happening in a matter of weeks.**
>
> Michelle Meyer, Chief US economics at Bank America Merrill Lynch

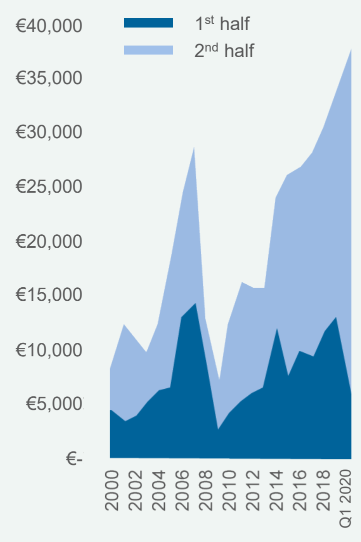
Indeed, the efforts made since the end of the 2000s have helped to strengthen the international financial system, which, together with the huge and unprecedented support measures announced by governments and central banks, **could help to cushion the shock of the pandemic.**

Investment volumes in France, breakdown by nationality



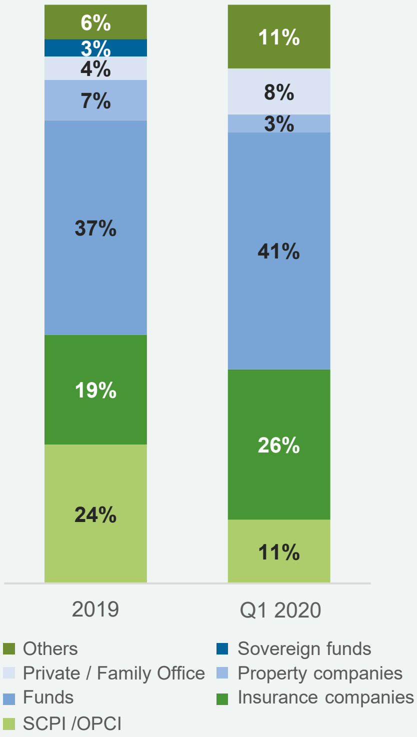
Source: Knight Frank

Investment volumes in France, all asset categories
In millions of euros



Source: Knight Frank

Investment volumes in France, by type of buyer, as a %



Source: Knight Frank

Nevertheless, several questions remain. Since the Minister of the Economy and Finance recently urged economic players, and in particular banks, to "play the solidarity game" by helping to safeguard businesses and jobs, **could this shift in the banking system in favour of the real economy limit the sums allocated to the financing of commercial real estate? Inflows will also have to be carefully analysed**, as some French people will most likely see their savings capacity eroded by the economic slowdown. In 2019, inflows had reached record highs, with a 20% year-on-year increase in life insurance and a 57% year-on year increase in SCPI/OPCIs. The latter had also increased their investments in the French property market, with a 24% share of investment volumes in France (19% in 2018), albeit down to 11% since the beginning of 2020. Although the figure for SCPI/OPCI inflows in Q1 2020 is not yet known, the figure for life insurance, on the other hand, shows a first tendency, with a 58% year-on-year decrease at the end of February. Could this drop, which is related to the decrease in yields, be exacerbated by the health crisis?

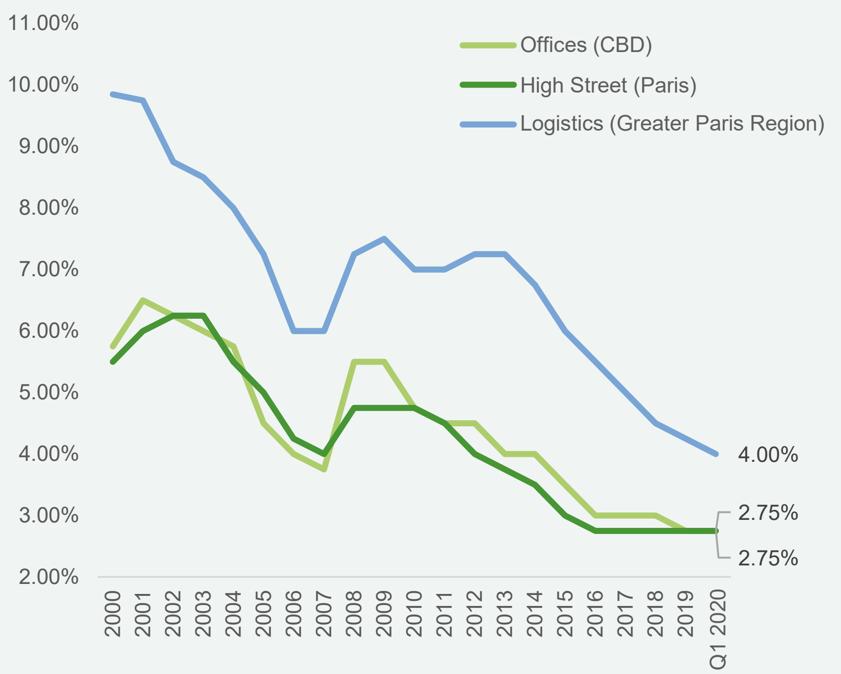
What will become of SCPI/OPCIs, whose appeal could be diminished by the high level of uncertainty surrounding the economy and the performance of the real estate sector?

In spite of everything, real estate should still keep a prominent place in investors' investment strategies. **Indeed, the French market is entering this crisis with better fundamentals than in previous crises**. The spread, which clearly favoured the real estate sector before the outbreak of the health crisis (a spread of 275 bps with the 10-year OAT rate at the beginning of 2020 compared to 215 bps in 2008) should thus remain positive due to the support measures taken by the State and the ECB. As for the equity markets, they are very turbulent. Moreover, LTV levels are significantly lower than those seen before the 2008 financial crisis. Finally, the good health of the rental markets, with historically low vacancy rates and peak rental values in certain office hubs, gives reason to hope for a less severe crisis. Investors will judge the various market sectors by their resilience. **They will therefore give preference to core assets in order to secure their rental streams against a background of rising business failures and rising vacancy rates.**

This will only accentuate a trend that was already underway before the outbreak of the health crisis, since the acquisition of core assets accounted for close to two-thirds of office investment volumes in the Greater Paris Region in 2019 and as much as 75% in Q1 2020. This increased market polarisation in favour of core assets could mitigate the rise in prime yields. Prior to the Covid-19 crisis, prime yields were at a historically low level of 2.75% for the best office assets in the CBD, 100 basis points below the level recorded before the 2008 financial crisis. **On the other hand, the health crisis is likely to put an end to the yield compression on secondary assets or assets in need of improvement, thereby restoring a risk premium that had tended to be eroded in recent years.**

Investors' enthusiasm for logistics, whose strategic role has been so obvious since the beginning of the lockdown period, should also increase, while other asset types, directly and heavily impacted by the health crisis (shops, hotels, etc.) will be subject to greater selectivity.

Change in prime yields



Source : Knight Frank

But these transformations could run deeper than a simple market shake-up. Before Covid-19, several epidemics had already marked the beginning of the 21st century, such as SARS, H1N1 and Ebola, and it is now clear that other scourges could appear in the years to come. This will lead investors and the entire real estate industry to better assess the health risk. In the office sector, for example, buildings and workspaces will have to be upgraded to ensure the safety of employees in the event of a new crisis. **The Covid-19 crisis is also likely to encourage investors to better integrate other types of risk into their allocation strategy that, like climate change, could be a source of major upheaval.**

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