Office property market
Lettings and investment market

Paris Ile-de-France Office Market

2nd quarter 2020

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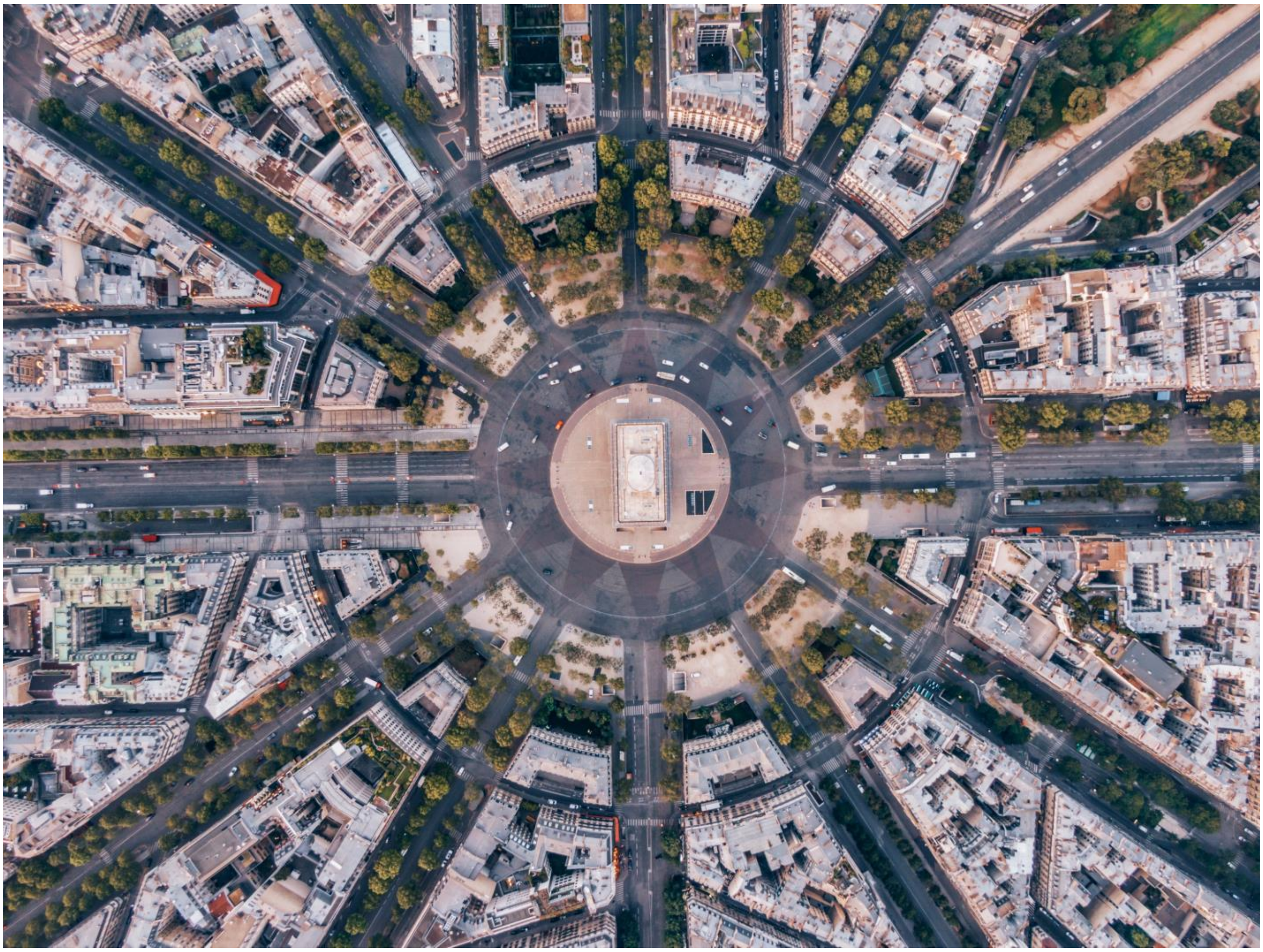
BETWEEN LOCKED DOWN AND OPENED UP

Knight Frank France reviews H1 2020 and continues its analysis of the consequences of the Covid-19 pandemic on the Ile-de-France office market.



ECONOMIC ENVIRONMENT

A FRAGILE RECOVERY

In 2020 the world will experience a recession of historic proportions, with annual GDP down an average of 4.9%. The shock will be harshest in developed countries (–8% vs. –3% in emerging and developing countries) and especially the eurozone, where the IMF forecasts a decline of 10.2%. Unlike in certain emerging countries and the United States, Covid-19 numbers in Europe have improved, though a second wave cannot be excluded. This is the case in France, whose economy was one of the hardest hit because of the severity of the lockdown. Nonetheless, the economy has bounced back faster than expected. INSEE now expects GDP to fall 9% in 2020, whereas a few weeks ago the Banque de France forecast a decline of 10.3%. In comparison, GDP fell 2.6% in 2009 – a clear indication of just how brutal the effects of Covid-19 have been on the French economy. The government has clearly learned from previous crises.

According to Finance Minister Bruno Le Maire, government support measures represent "*twenty percent of French national wealth*" and serve mainly to help companies meet liquidity risk. The massive use of state-subsidized furlough for 14 million persons since March (including 7.8 million still benefitting from the system at the end of May) also helped cushion the blow. A sharp rise in unemployment is nonetheless expected, with the unemployment rate growing from 8.1% at the end of 2019 to more than 10% at the end of the 2020, before peaking at 11.7% in 2021.

The tendency of households to spend their "forced" savings accumulated during the lockdown, the extent of investment contraction and the deteriorated state of France's main trading partners all raise questions as to the solidity of the economic recovery. The French economy has already been badly weakened, though the damage varies across sectors and regions. The aeronautics sector will be one of the worst affected in the long term, with significant impact on unemployment in the provinces. In Ile-de-France, two of the hardest hit sectors have been tourism and retail, after an already challenging 2019 which was complicated by the Yellow Vest demonstrations and transport strikes.

Other sectors in trouble are those of events planning and services. The number of bankruptcies is expected to rise significantly. Companies that manage to continue their business activities will be forced to make hard choices about their largest recurring costs. According to a survey conducted by Xerfi, the main sources of savings would come from salaries (64%), budget cuts relating to corporate consulting and services (62%), reduced advertising and marketing budgets (57%) and debt restructuring (48%) – all well ahead of property costs (43%).

Macroeconomic projections, France

	2016	2017	2018	2019	2020	2021	2022
Real GDP	1.0	2.4	1.7	1.3	-10.3	6.9	3.9
Household consumption	1.6	1.6	0.9	1.3	-9.3	8.4	4.3
Business investment	3.1	5.5	3.2	4.2	-23.3	17.4	8.6
Exports	1.8	4.0	3.5	2.0	-14.3	8.5	4.5
Imports	3.0	4.1	1.2	2.3	-12.9	9.0	5.4
Real household gross disposible income	1.6	1.4	1.2	2.1	-0.5	0.9	2.1
Net job creations (thousands)	177	275	341	284	-552	-335	427
Unemployment rate (France, % of labour force)	10	9.4	9.0	8.4	10.1	11.7	10.4

Source: Banque de France, June 2020

For some companies, however, the crisis could turn out to be an opportunity. This is the case of French tech start-ups, whose fund raising slowed only slightly year on year, with €2.7 billion raised in H1 2020 (–3.5% in value). Momentum is still high in sectors such as fintech, medtech and online retail. French tech growth could increase demand for office space in Paris. Other companies in other business sectors could use property to leverage costs down, either by regrouping employees or by moving into areas with lower rents. Ile-de-France should be able to soften the effects of the crisis by means of its wide diversity of occupiers and property solutions.

COMPANIES FACING THE COVID-19 CRISIS

BESIDES JOBS, WHAT ARE THE PRINCIPAL SOURCES OF SAVINGS YOU INTEND TO MAKE USE OF? SHARE IN %

- 63.9% Salary adjustments
- 62% Decrease in consulting and other corporate services
- 57.3% Lower advertising and marketing expenses
- 47.8% Renegotiation and restructuring of debt
- 43.2% Lower property spending (smaller offices, etc.)

Source: *Companies and Covid-19, 3rd wave of the survey*, XERFI, June 2020. Survey of 600 managers and directors.

THE LETTINGS MARKET

THE WORST QUARTER IN 20 YEARS

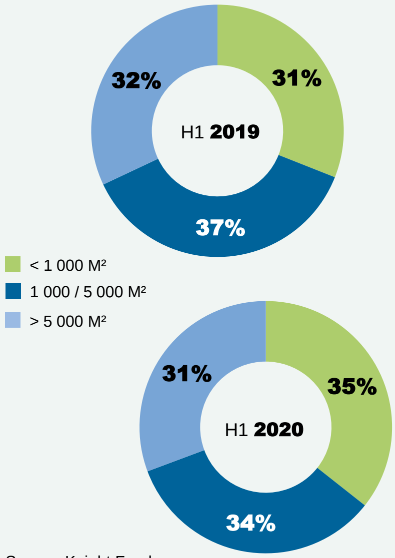
After all but shutting down during the two months of lockdown, rental activity has slowly resumed since mid-May. Though economic recovery has been better than expected and the health crisis has improved, lettings have been very slow since the economy opened up again. There were 195,000 m² of office take-up in Q2, a decline of 65% compared with Q1 2020 and the worst quarterly performance in the past 20 years.

It is also a reflection of the shock that Covid-19 has had on the Ile-de-France office market. Before this the worst performances had been in Q1 2002 (299,000 m²) and Q3 2009 (366,000 m²) – the low point of the market after the financial crisis began in 2008.

Total take-up year-to-date stands at 755,000 m², including Q2 lettings. H1 2020 lettings are down 33% compared to H1 2019, and down 31% compared to the ten-year average. Although the decline is substantial, it was limited by Total's Q1 leasing of 125,000 m² in The Link in La Défense. This deal was the largest made in the Paris region since the regrouping of the Defence Ministry in Balard in 2012 (135,000 m²), and alone accounted for 54% YTD of take-up of assets greater than 5,000 m².

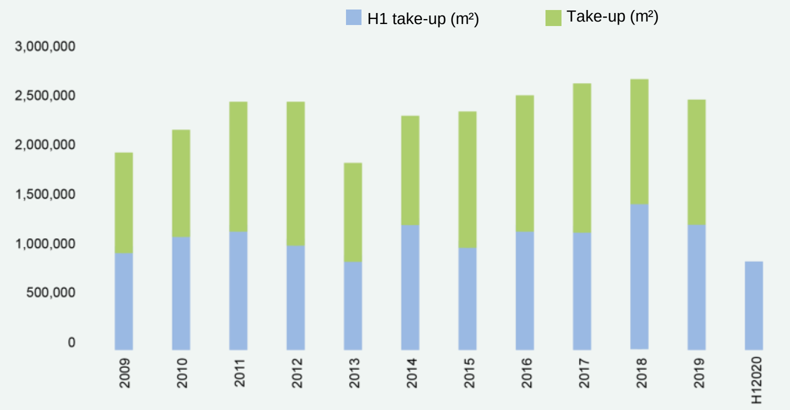
There have been only 14 transactions in this segment since the beginning of the year, compared with 34 in H1 2019. Other segments experienced sharp declines: 39% year on year for office assets of intermediate size (1,000–5, 000 m²), and 23% year on year for office assets of less than 1,000 m².

Change in take-up
In the Greater Paris Region



Source: Knight Frank

Take-up change in the Greater Paris Region
In m²



Source: Knight Frank

LA DÉFENSE: THE EXCEPTION

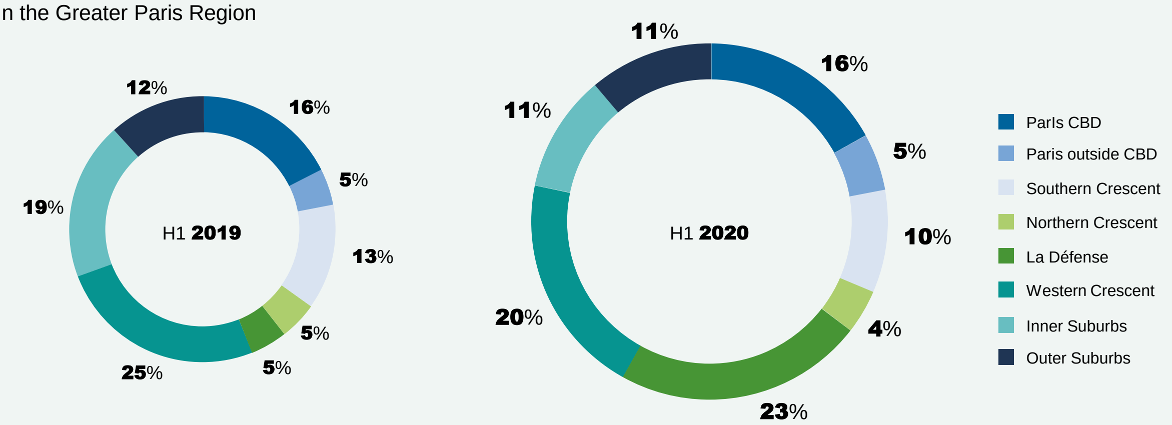
All the major tertiary sectors in Paris and the surrounding region experienced a year-on-year decline in take-up in H1 2020, with one exception: La Défense. The business district enjoyed its second-best performance ever, with lettings of nearly 170,000 m². Only H1 2016 was better, and that was because of eight major deals (Saint-Gobain in M2, Deloitte in Majunga, etc.), compared to only two transactions of more than 5,000 m² in H1 2020. One of the projects, Total's lease of 125,000 m² in The Link, is exceptional. The high level of take-up in La Défense appears in stark contrast with the decline in lettings in neighbouring sectors.

Nevertheless, the new Engie campus of 135,000 m² in La Garenne-Colombes, for which the city has recently granted building permits, will soon boost take-up for the area.

After La Défense, it was inner Paris which had the most take-up in H1 2020 of office assets greater than 5,000 m², thanks to seven deals totalling 62,000 m². Nonetheless activity fell by half compared to H1 2019 (14 deals for 118,000 m²) as a result of a Q2 with only one large deal, Goldman Sachs's lease of 6,500 m² for its new headquarters at 83 avenue Marceau in the 16th arrondissement. This deal follows JP Morgan's acquisition at the beginning of the year of a property of similar size at Place du Marché Saint-Honoré, a deal concluded despite the outbreak of the Covid-19 crisis. Above all, the Goldman Sachs deal confirms the appeal of the Paris financial sector at a time when negotiations have stalled between the UK and the EU, making a "no deal" more and more likely. A total of 269,000 m² were let in Paris in H1 2020, all property sizes included. This figure is far from the performances during the euphoric period 2016–2018, when take-up averaged more than 500,000 m² in the first half of each year. However, take-up in H1 2020 is better than take-up during the low point of the two major crises in the noughts (228,400 m² in H1 2002 and 239,500 m² in H1 2009). Business has held up best in the CBD, falling 35% year on year compared with 40% in north-eastern Paris and 51% in southern Paris (i.e. the Left Bank and the 12th).

In the inner suburbs, volume let fell even faster in the second quarter. Only 80,000 m² were let in all of H1 2020, of which a little more than half was in the northern suburbs as a result of two large deals signed at the beginning of the year in Clichy (BIC in the E-Conic building) and Saint-Ouen (Ecole Danhier in Saint-Ouen 1 & 2). The southern suburbs didn't do as well, with less than 25,000 m² taken up since the beginning of 2020 (-68% year on year).

Take-up by geographical sector (H1 2020 vs. H1 2019)
In the Greater Paris Region



Source: Knight Frank

For the past two years this sector had been enjoying strong growth thanks to its high-quality supply, to deferments of Parisian occupiers and to progress on line 15 Sud of the Grand Paris Express. Even with delays caused by Covid-19 – projected at three to six months for the lines under way, according to Société du Grand Paris – the realisation of this major project and its proximity to Paris remain vital criteria for occupiers. Since the beginning of the year, the communes bordering Paris (Montrouge, Clichy, Saint-Ouen, Aubervilliers, etc.) and some of the future hubs of the Grand Paris Express (Saint-Denis, Fontenay-sous-Bois) account for almost all lettings in the inner suburbs. This trend began last year and continued into H1 2020. H2 could see a larger number of operations which meet corporate modernisation and cost-cutting objectives.

Examples of significant lettings transactions in H1 2020
In the Greater Paris Region

Asset / Address	Tenant	Area (m²)
The Link / Puteaux La Défense (92)	Total	125,000
L1ve, 75 av. de la Grande Armée / Paris 16th	Boston Consulting Group	20,000
Atlantis / Evry (91)	CAF	11,400
Life, 62 rue Jeanne d'Arc / Paris 13th	Groupe VYV	9,750
E-Conic / Clichy (92)	BIC	7,600
Saint-Ouen 1 & 2 / Saint-Ouen (93)	École Danhier	6,800
83 avenue Marceau / Paris 16th	Goldman Sachs	6,500
Hôtel de la Marine / Paris 8th	Morning	6,100
21 place du Marché Saint-Honoré / Paris 1st	JP Morgan	6,000
Quai Ouest IV / Suresnes (92)	Talend	5,300

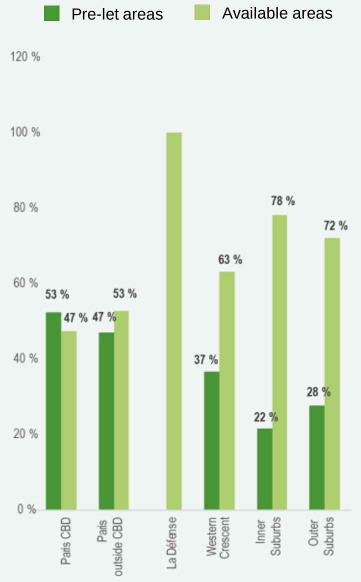
Source : Knight Frank

AVAILABLE SPACE AND RENTAL VALUES: A SECOND TRANSITIONAL QUARTER

With 2.99 million m² of office space immediately available in Ile-de-France, supply increased by 4% in Q2 and 9% YTD. This trend of rising supply was already under way when the virus appeared, and so far has remained moderate. The vacancy rate rose only 0.2% in Q2, to 5.5% at the end of June. Available space remains scarce in Paris (2.6%), even though that is where supply has increased the most – nearly 24% higher today than at the end of March, and 41% in the CBD since the arrival of supply on the market for second-hand small and medium-sized offices. In other sectors of Ile-de-France the situation is more or less stable. However, significant differences persist between well-supplied markets (Péri-Défense, northern inner suburbs) and those trending towards balanced supply (south-western suburbs) or even limited supply (eastern and southern inner suburbs).

The change observed over the past three months does not yet reflect the shock of the Covid-19 crisis. By contrast, higher supply can be expected as from Q3, when several projects for new and redeveloped offices will be completed.

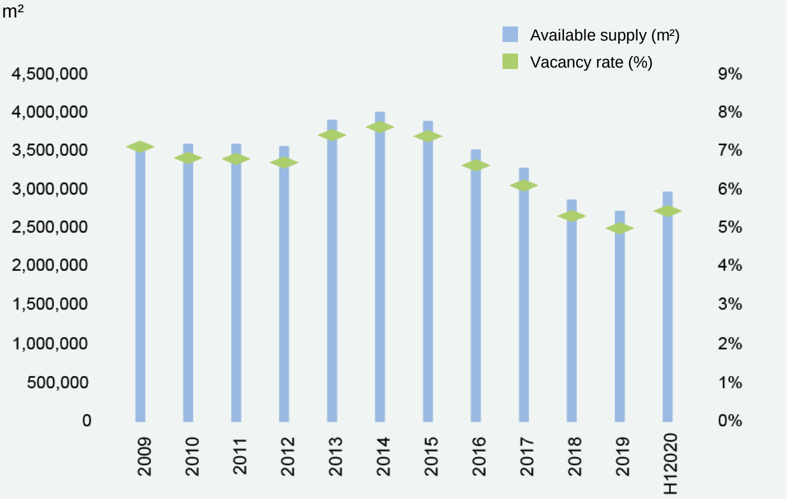
Pre-lettings by submarket
In the Greater Paris Region, deliveries expected between 2020 and 2022



Source: Knight Frank

Occupier demand, however, is not expected to recover significantly by Q3. Most deliveries of large properties will be in La Défense and the northern inner suburbs. While a few transactions could absorb part of those by the end of the year, pre-lettings are still rare – a sign of higher vacancy rates to come in both these sectors.

Change in available supply in the Greater Paris Region
In m²



Source: Knight Frank

By contrast, the rise in available space should be relatively contained in inner Paris, where nearly 60% of Grade A supply expected by the end of the year has already been let.

While the rise in available space is undeniable, it is difficult to estimate how much more there will be in the months to come. The first uncertainty stems from the delivery schedule. Although most projects have been resumed, the lockdown delayed their progress. Some owners may decide to postpone letting their projects in order to monitor the trends in occupier demand. The second question stems from Covid-19's impact on the economy. The health crisis will determine the extent of releases by companies, as well as the volume of office space offered as subleases.

The direction of rental values is still hard to read. Consequently, the Covid-19 crisis has not yet translated into economic numbers as seen in prime rents, which continued to rise in Q2 2020 to a record €920/m²/year. Prime rents rose 5% quarterly and 9% year on year, due largely to Goldman Sachs's new headquarters at 83 avenue Marceau. At €415/m²/year, the average rent in Ile-de-France has been stable since the end of Q1 2020, and even shown a slight uptick of 2% year on year. The next few months will provide a measure of the real impact of Covid-19 on rental values. Changes will depend on the extent to which supply recovers. A correction is expected in markets with the most abundant available space, such as La Défense and certain communes in the northern inner suburbs. Generally, the coming market will be more competitive, with occupiers more opportunistic and mobile, and thus able to make the most of new market conditions.

"BACK TO HUMAN"[1]

H2 will see a decline in take-up because of low visibility onto the economic consequences of the Covid-19 crisis. Nonetheless, the health crisis and need for cost-cutting do not mean there will be no property transactions whatever. Cost-cutting projects should give a boost to rental activity, particularly in certain sectors of the inner suburbs and western Ile-de-France. Other criteria must be taken into account with regard to trends in occupier demand, including health risks. These will be with us as long as a vaccine has not been developed and even afterwards, for we now live under the threat of other pandemics. Companies will have to include health risks in their property strategy.

Another profound change can be seen in new ways of living and working. For the moment, most companies are still trying to get their employees back to the office. Nonetheless, the health crisis has called into question how we organise our society, in France as well as in other countries.

These considerations cover numerous subjects relating to work and companies (shorter work weeks, life/career balance, staggered working hours, etc.) and will have consequences on the functioning of cities and property markets.

The rapid growth of working from home is the most widely discussed phenomenon, even though at present it is impossible to measure the real impact of this on the consumption of office space. We have not yet seen an officeless company, and examples of "full remote" are still rare indeed. Moreover, numerous surveys carried out since the end of the lockdown have shown that employees do not wish such a radical upheaval. For most employees, working from home should be limited to one or two days a week, in order to reallocate part of the time saved by not having to commute to the office every day. In such an organisational scheme, the office retains its vital role. One of the consequences of the Covid-19 crisis has been to remind us of the importance of human contact, and to emphasize the crucial role offices play in the social fabric.

As we anticipated in a study published at the beginning of the lockdown, the tidal wave brought on by Covid-19 does not call into question the importance of office buildings. We continue to support a hybrid scenario, with remote work growing parallel to the consolidation of offices as social spaces which promote well-being, productivity and corporate innovation.

> **"In the future the office will be even more of a "tool" – one of the most important – for the creation of a company's economic and social value."**
>
> Onepoint, "*Telecommuting, forced and locked down: impacts and outlooks*", May 2020.

[1] Title inspired by Dan Schwabel's *Back to Human: How Great Leaders Create Connection in the Age of Isolation*, Piatkus 2018.

THE INVESTMENT MARKET

TOTAL INVESTMENT DOWN 48% IN Q2

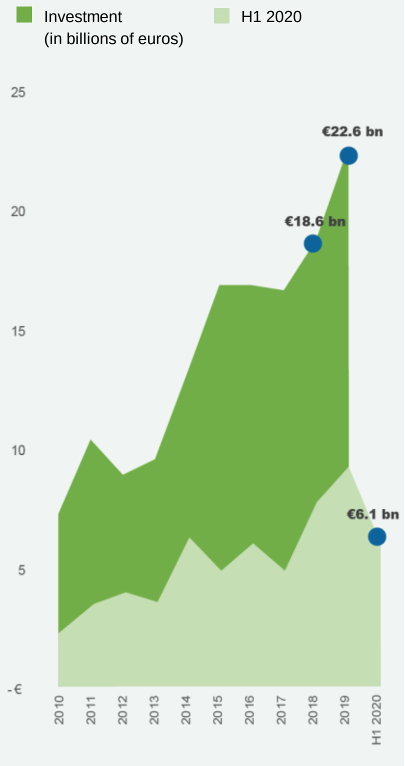
Year to date, €6.1 billion has been invested in the Ile-de-France office market, 33% less than in the first half of 2019. This is nonetheless 19% more than the ten-year average, thanks to a record-breaking start of the year and to several large deals which were initiated before the lockdown and have since been finalised. It wasn't until Q2 2020 that the Covid-19 crisis really began to hurt business, with €2.1 billion invested, compared with €4 billion in the first quarter – a significant decline of 48% attributable to a fall in the number of transactions (38 of all sizes in Q2 2020, compared with 52 in Q1) and fewer large deals. After 13 deals for more than €100 million in the first quarter, only seven were finalised in the second quarter, a 61% investment decline quarter on quarter. As a result, the office investment market has temporarily lost its growth engine. Medium-sized deals (€50–100 million) also declined, with only five finalised in Q2 2020 for a total of €400 million, 37% less than in the first quarter.

After the year got off to a solid start, investment declined significantly in inner Paris. Investment in offices in Q2 2020 came to €1 billion, bringing the H1 total to €3 billion (–40% year on year).

This sharp fall was unsurprising, as last year's performances had been boosted by two huge deals worth more than €1 billion each: Terreïs's sale to Swiss Life of a portfolio of 28 assets located mainly in the CBD, and the acquisition by Samsung and Primonial of the Lumière building in the 12th arrondissement.

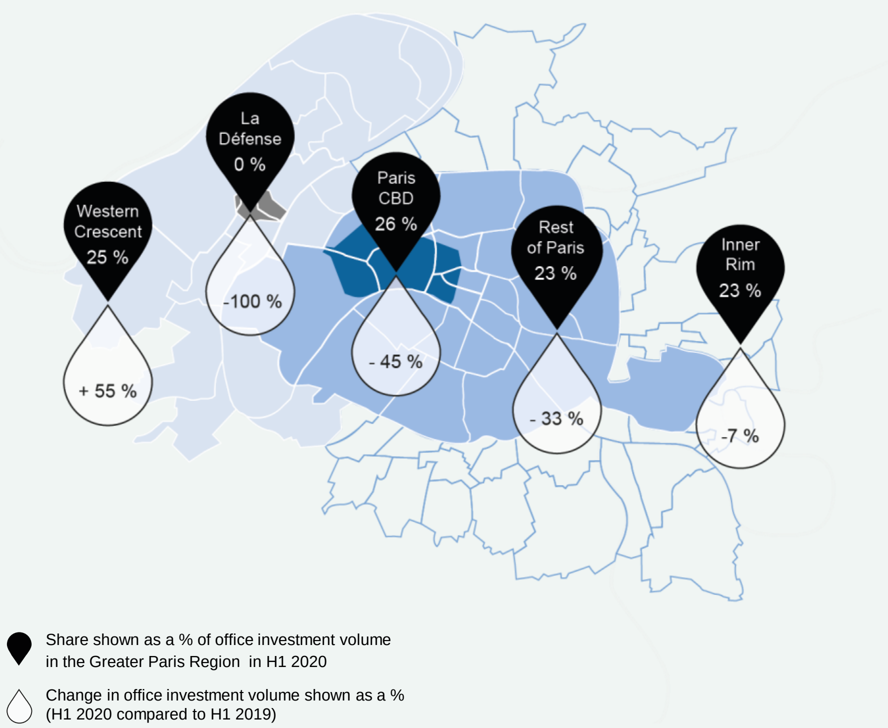
Although a few large-scale deals were made recently in eastern Paris (Unofi's acquisition of the new BlaBlaCar headquarters, near La Bastille, and PGIM's sale of 42–44 rue de Paradis in the 10th), most were in established tertiary sectors in western Paris (e.g. Ardian's sale of 46–48 avenue de la Grande Armée).

Change in office investment volumes in the Greater Paris Region



Source: Knight Frank

Geographic breakdown of office investment volume in the Greater Paris Region

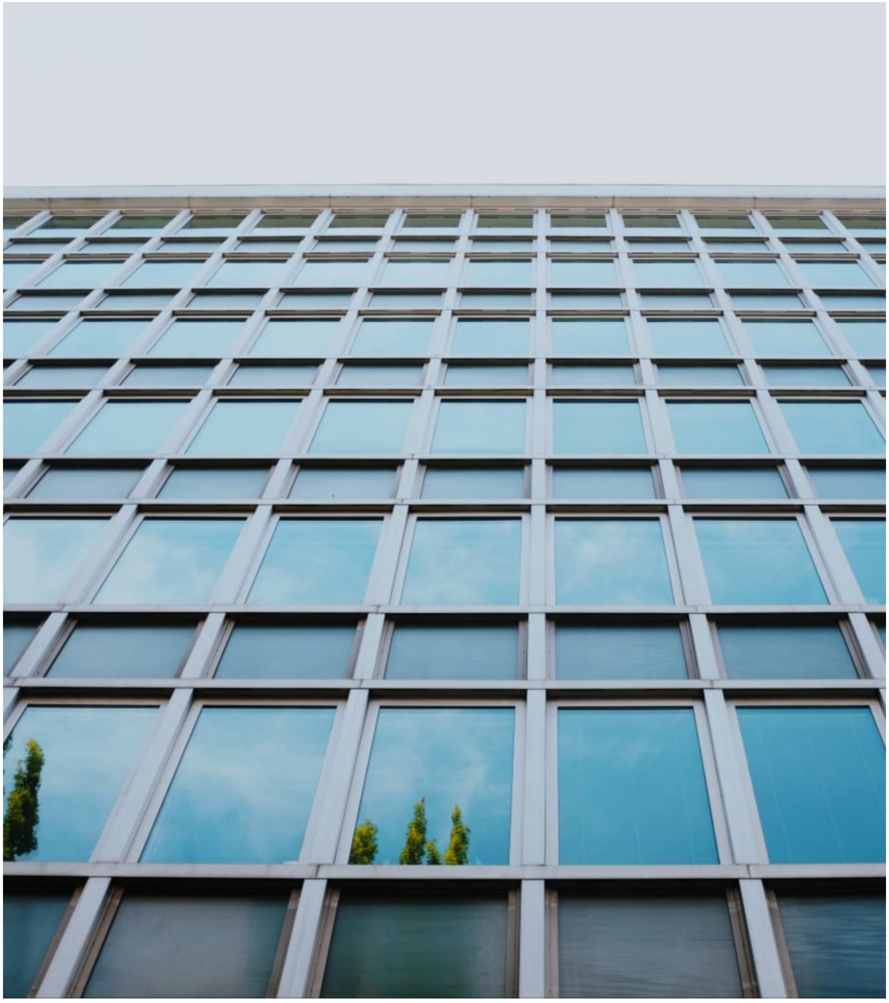


Source: Knight Frank

In the inner suburbs and outskirts, the Grand Paris Express hubs remain a choice target for investors, despite lockdown-related delays at the sites of future Metro lines. Consequently, the project remains a vital engine for the long-term attractiveness of Ile-de-France. Recently finalised deals include the new headquarters of the Conseil Régional d'Ile-de-France in Saint-Ouen (Influence 2.0), acquired by BNP Paribas Reim, and the speculative sale to Ivanhoé Cambridge of the 50,000 m² Joya project in Fontenay-sous-Bois. There were very few transactions elsewhere in Ile-de-France, and the best-known tertiary sectors in the western part of Ile-de-France were especially quiet. However, several deals are being finalised, including some large ones in the south-western suburbs.

NUMEROUS QUESTIONS ABOUT THE MONTHS AHEAD

What should we expect over the next few months? With uncertainty still very high, it is difficult to answer this question. As long as Covid-19 is circulating in France, a second wave cannot be ruled out, even though the



Significant investment deals in Ile-de-France in H1 2020

Asset	Seller	Purchaser	Area (m²)
14 rue Bergère / Paris 9th	BNP Paribas	LaSalle IM	33,000
Aquarel / Issy-les-Moulineaux (92)	Axa	CNP Assurances	33,500
Joya / Fontenay-sous-Bois (94)	Europequipements	Ivanhoe Cambridge	48,900
Le Valmy / Montreuil (93)	Gecina	Primonial Reim	29,450
Influence 2.0 / Saint-Ouen (93)	Nexity	BNP Paribas Reim	25,000
50 rue d'Anjou / Paris 8th	Crédit du Nord	Aviva Investors	10,600
On Seine / Levallois-Perret (92)	AGC Equity Partners / EDF Invest	ACM	16,000
46-48 avenue de la Grande Armée / Paris 17th	Ardian	Cardif	8,100
79-81 boulevard Haussmann / Paris 8th	Groupe Roullier	Alduwaliya AM	5,700
SoCo / Paris 9e	Groupama	Aviva Investors	5,500
6-8 rue Saint Sabin / Paris 11st	6e Sens Immobilier	Unofi Assurances	4,800
Olympe / Saint-Denis (93)	AEW Ciloger	Unofi	15,300
Respiro / Nanterre (92)	Covivio	Voisin	11,200

Source: Knight Frank

latest indicators from the Health Ministry are encouraging. However, even though the French economy has restarted faster than expected, the impact of the crisis on businesses and employment will be significant. Looking beyond France, numerous clouds are gathering on the horizon: a no-deal Brexit, an economic and social crisis in the US with the presidential election coming up, slower growth in emerging markets, etc. These will all impact the French investment market, which is highly correlated to the global economy.

This is why investors are being so cautious and selective. One of the most challenging questions at present is about the future of the rental market, as well as the acceleration of structural change (telecommuting, online retail, CSR, etc.) The uncertainty surrounding such changes requires a rethinking of the traditional models on which office and retail properties have been based for decades. The risk of further Covid-19 contamination, the growth of telecommuting and the looming economic shock all raise questions as to just how long tertiary assets can hold up. While the current lack of visibility explains the reticence of investors, who are being very careful about the quality of tenants and locations, the future of office properties is still bright.

The most recent deals, as well as those under negotiation, show that office properties with solid fundamentals are still the most attractive assets in the French property market. Since Covid-19 raises short-term concerns such as the solidity of tenants, investors are inclined toward the most liquid sectors and toward sectors whose occupier profiles are the most varied. This situation benefits the Paris market, where corporate demand has been relatively steady, and where lower vacancy rates foreshadow a more modest decline in rental values. Another major worry is the tightening of financing conditions.

Although banks favour no one product category, they are more especially reluctant to finance core + and value-add assets. Combined with asset repricing and the lack of visibility in rental markets, this deterioration in financing availability could slow or even stop deals from being finalised. Market conditions also slow investment by foreign investors.

Before the explosion of Covid-19, foreign investors accounted for nearly half the market of assets requiring improvement. Moreover, since the end of Q1 2020, foreign investors have initiated very few acquisitions of prime assets, though several large deals are in their final stages. And while France is still at the heart of cross-border investment strategies, the decline of foreign investors automatically increases the share of French investors, which provided nearly 60% of total investment in H1 2020. OPCI/SCPI vehicles and insurers accounted for almost all significant deals over the past three months (e.g. Influence 2 in Saint-Ouen acquired by BNP Reim, L'Olympe in Saint-Denis acquired by Unofi).

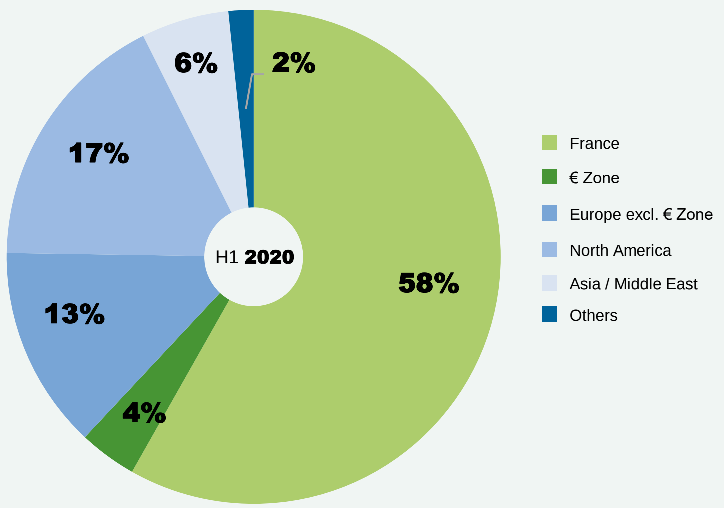
Domination by French investors is expected to continue in H2, though fund inflows will need to be monitored carefully. SCPI trusts took in less money in Q1 before picking up again in May. Life insurance inflows, however, have been negative since March.

A BRIGHTER FUTURE?

Effects of the Covid-19 crisis are still resonating throughout the French investment market. Although H1 2020 results may be down "only" 33% from those of H1 2019, the decline could be much worse in H2. With €13.5 billion invested in Ile-de-France office properties, H2 2019 was exceptional – a performance impossible to repeat this year. Investment in 2020 will be significantly less than in 2019 (€22.6 billion), but it may be close to the ten-year average (€14 billion). Regardless, investment will be much greater than levels seen during the last financial crisis (€3.7 billion in 2009). Business should begin to pick up in Q3 and then further improve in Q4, traditionally the best quarter of the year. This optimistic outlook is based on analysis of sales already under way, and on encouraging health and macroeconomic indicators.

Office investment volume by nationality

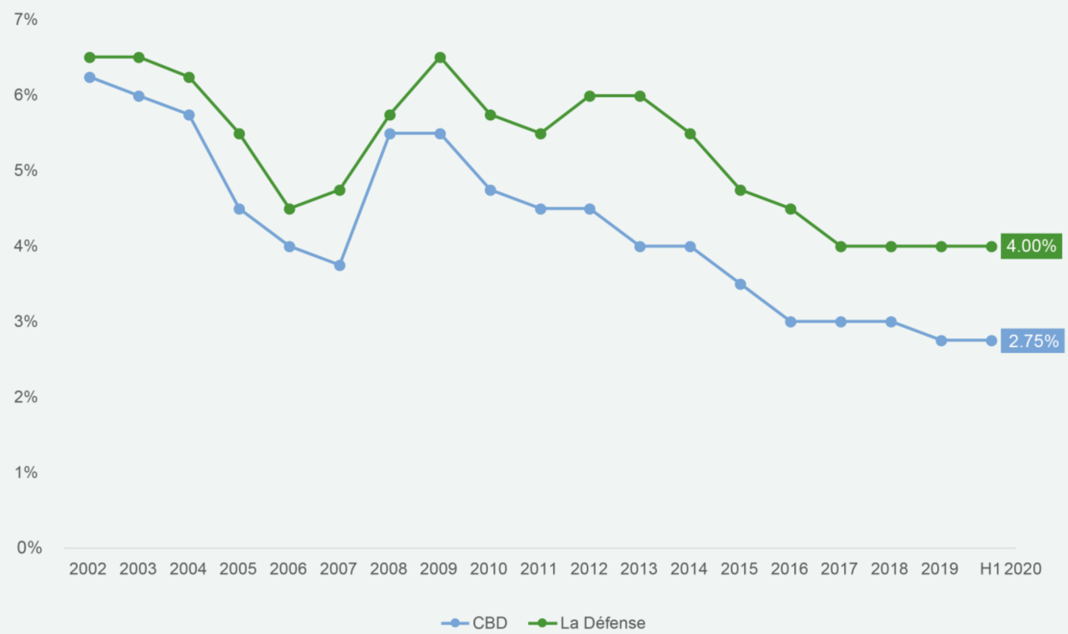
In the Greater Paris Region



Source: Knight Frank

Above all, property as an asset class continues to be viewed as a safe-haven investment, even though investors are increasingly nervous. In contrast with the volatility of financial markets, the limited correction of prime yields, as well as a spread that is still largely positive, allow investors to look beyond Covid-19 despite risks related to the health crisis. Let us not underestimate the harm done to the French investment market by Covid-19. In addition to the decline in investments, many certitudes have been shaken and the world must, at least in part, be reinvented. However, fundamentals remain solid and lend hope for a rapid return to better times.

Change in office prime yields
In the Greater Paris Region



Source: Knight Frank

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