The Office Market
Lettings and Investment

Paris Ile-de-France Office Market

3rd Quarter 2020

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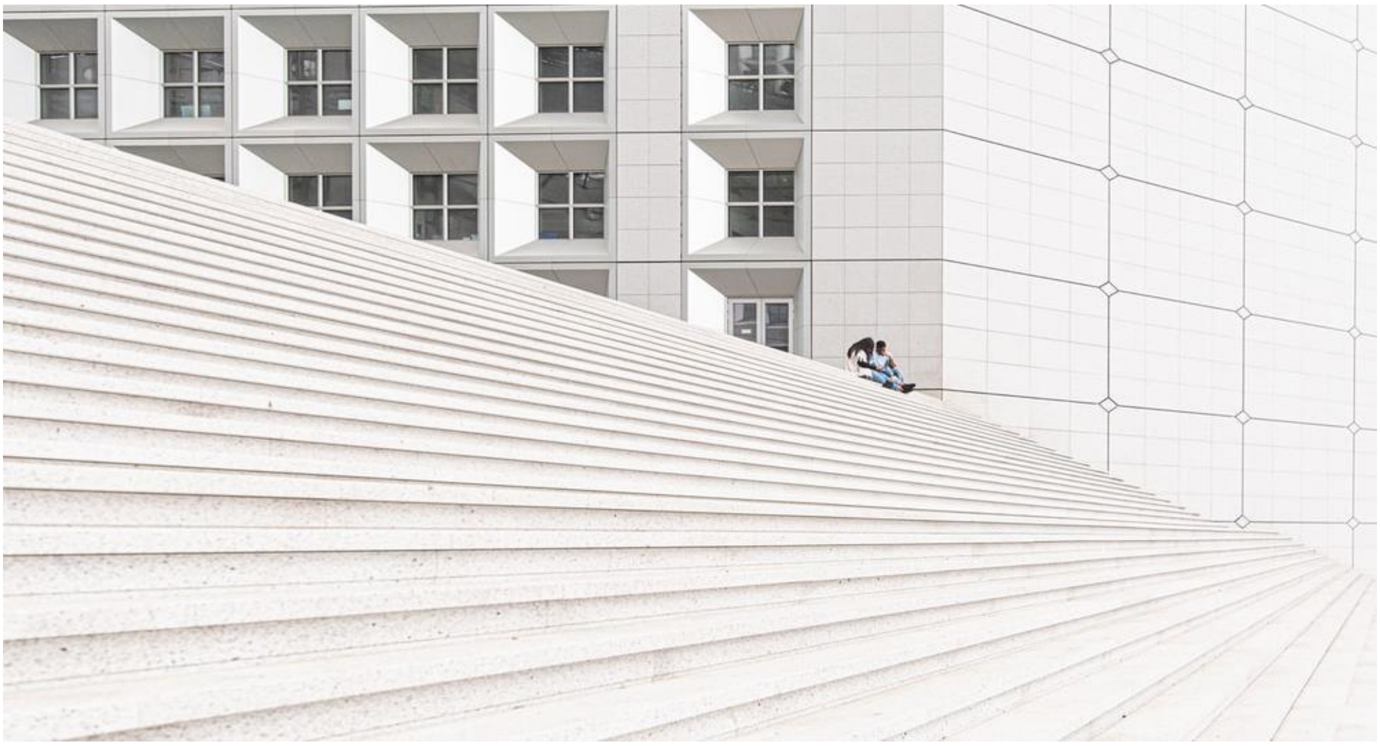
FACING THE SECOND WAVE

After a very poor 2nd quarter 2020, the slowdown in infections and the recovery of the economy may have inspired optimism, but did not result in an upturn in activity in the 3rd quarter. Despite a slight improvement, the rental and investment markets are significantly down on last year, even though acquisition volumes are fairly high compared with the long-term average.

The 4th quarter, which is usually the busiest of the year, will provide further indications as to the resilience of the Greater Paris Region market. The amounts invested and areas leased are expected to be higher than in the 3rd quarter due to the completion of several major transactions. However, the arrival of a second wave of the pandemic and the further weakening of the economy will fuel the wait-and-see attitude of both occupiers and investors, likely postponing a more solid recovery in the office market until 2021.



ECONOMIC CONTEXT

HOPES DASHED

After a 2nd quarter overshadowed by the lockdown, optimism was rather high at the beginning of the summer period. The drop in infection numbers and the sharper-than-expected rebound in economic activity had even led the Banque de France to readjust its growth forecasts, predicting a contraction of 8.7% for 2020 as a whole, compared with -10.3% previously. Alas! New infection cases continued to multiply from August onwards, forcing the authorities to place certain areas on maximum alert from the end of September.

For now, INSEE maintains its forecast of a 9% annual GDP contraction. However, the second wave seems likely to jeopardise the continued recovery of activity. This is due to the introduction of new restrictive measures, which particularly affect the sectors already hit, such as tourism and accommodation/catering. According to the Union of Hotel Trades and Industries, 15% of the bars, hotels, restaurants and nightclubs in France (30% in the Greater Paris Region) are consequently in danger of closing permanently.

The worsening health crisis also affects household morale. They will therefore probably be less inclined to spend the savings accumulated since the lockdown, even though consumption is one of the keys to the recovery of the French economy. Finally, the resurgence of the pandemic concerns countries other than France, so travel restrictions will remain in place and continue to weigh on international trade.

Forecast loss of activity by sector in France
Difference from pre-crisis level (Q4 2019)

	Share of GDP (%)	Loss of activity in Q2 2020 (%)	Loss of activity in Q3 2020 (%)	Loss of activity in Q4 2020 (%)
Agriculture, forestry and fisheries	**2**	**- 6**	**- 3**	**- 2**
Industry	**14**	**- 23**	**- 6**	**- 4**
Construction	**6**	**- 32**	**- 5**	**- 5**
Primarily trade services	**56**	**- 17**	**- 7**	**- 7**
• Retail	10	- 20	- 4	- 3
• Transport and storage	5	- 28	- 19	- 20
• Accommodation and catering	3	- 53	- 22	- 31
• Information and communication	5	- 9	- 4	- 4
• Financial and insurance activities	4	- 8	- 3	- 0
• Real estate activities	13	- 3	- 0	- 0
• Scientific and technical activities	14	- 19	- 8	- 6
• Other service activities	3	- 36	- 16	- 17
Primarily non-trade services	**22**	**- 17**	**- 3**	**- 3**
Total	**100**	**- 19**	**- 5**	**- 5**

Source: INSEE

On the 5th October, Paris and its Inner Suburbs were placed on maximum alert, and are among the areas most affected by the Covid-19 pandemic due to an economy geared towards the outside world and the major difficulties of important sectors such as tourism and the automobile and aeronautics industries. The number of jobs lost in the first half of the year alone totalled almost 180,000. In France, between 800,000 and 900,000 jobs are expected to be lost over the whole year. The unemployment rate could therefore approach 10% by the end of 2020 (9.7% according to the latest INSEE economic report), and exceed 11% in 2021. It should be remembered that at the beginning of the year unemployment had fallen to its lowest level for ten years (7.6% in Metropolitan France and 7.0% in the Greater Paris region).

It is within this context, completely unprecedented in the suddenness and scale of the crisis, that the government unveiled a €100 billion recovery plan on the 3rd September (i.e. about four GDP points for the next two years). This completes the emergency plan of €57 billion and notably aims to reduce production taxes by €10 billion per year. Several other schemes provide greater support for businesses, such as the State-guaranteed loan and the solidarity fund for small companies and the self-employed, thanks to reduced corporate tax rates of 15%.

THE LETTINGS MARKET

NO IMPROVEMENT IN THE 3RD QUARTER

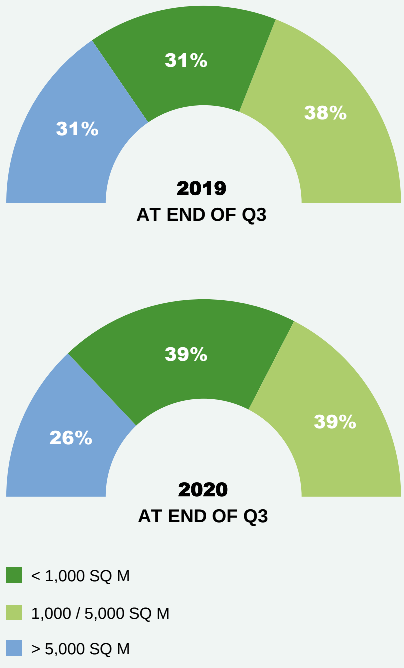
Despite the upturn in economic activity and the relatively strong return of employees to the workplace, the office market in the Greater Paris Region did not see a recovery in rental activity in the 3rd quarter 2020. In fact, economic difficulties, the fear of a second wave – which France has finally entered – and the uncertainty linked to the pandemic's progress have continued to fuel the wait-and-see attitude of companies, faced with the health emergency and engaged in cost-cutting issues rather than in making overly committing real estate decisions.

Following take-up of 194,000 sq m in the 2nd quarter 2020 – a historically low level for a quarter – take-up amounted to 275,000 sq m over the last three months. This volume remains very modest, with a 50% decrease year-on-year and a 53% drop compared with the ten-year average. It should be remembered that the worst 3rd quarter so far dates back to 2002, when 330,000 sq m was let.

Over a full year, 2002 was also a historic low point in the Greater Paris Region office market, with take-up of 1.48 million sq m of office space. This volume may well not be reached this year. 1.01 million sq m were let or sold to occupiers in the first nine months of 2020, down 40% year-on-year and compared with the ten-year average.

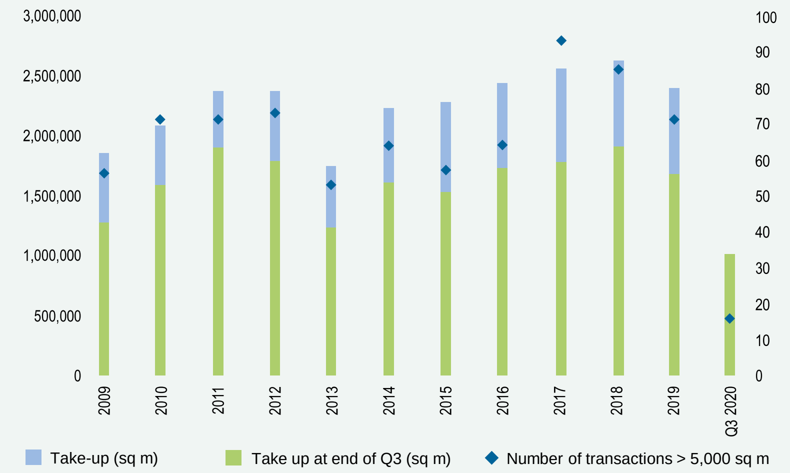
Whilst all area categories are clearly on a downward trend, both in number and volume, it is the large transactions category (> 5,000 sq m) that is the most affected. Although 12 transactions were signed in the 1st quarter in the Greater Paris Region (including TOTAL's lease on the 125,000 sq m of "Link" in La Défense), only four have since been signed, two in the 2nd quarter and then two in the 3rd quarter. These 16 large transactions represent a total of 258,000 sq m, a sharp 51% drop year-on-year.

Breakdown of take-up by area category
In the Greater Paris Region



Source: Knight Frank

Change in take-up
In the Greater Paris Region



Source: Knight Frank

In the 4th quarter, activity should pick up in the large area category. Several transactions, most of which were initiated prior to lockdown, are in the process of being finalised. That said, transactions of more than 5,000 sq m will most likely total less than 30 in the Greater Paris Region over the whole of 2020, compared with an average of 70 per year for the past ten years.

The other area categories are also struggling, but with a less marked decrease of 43% year-on-year in the take-up volumes in the mid-range office area category (1,000 to 5,000 sq m), and 24% year-on-year in the area category below 1,000 sq m.

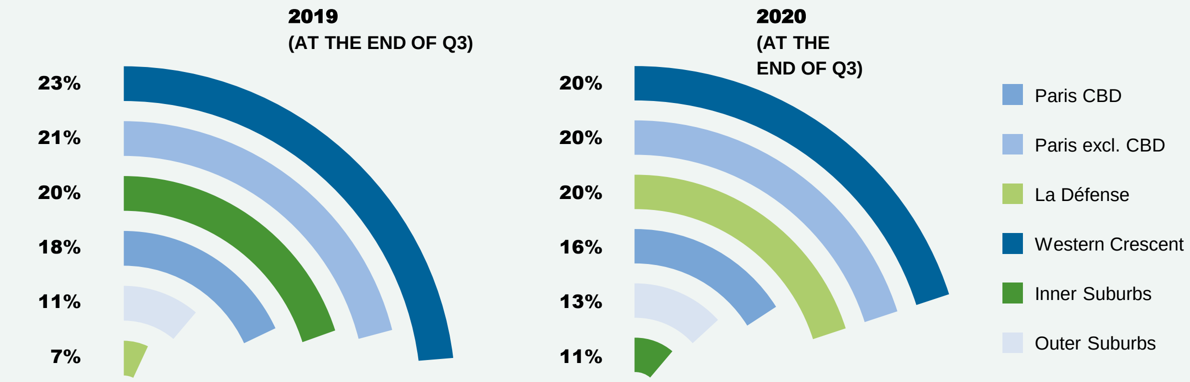
LA DÉFENSE IN THE SPOTLIGHT

Benefiting from the signing of a transaction exceeding 20,000 sq m in the 3rd quarter and, above all, the letting to TOTAL of the 125,000 sq m in "Link" in the 1st quarter, La Défense is the only market to post a year-on-year increase in take-up volumes (+74%). Despite a limited number of transactions, the business district could even achieve one of the best performances in its history in 2020. Moreover, this success could continue into 2021 due to an abundant supply and more favourable negotiation conditions for occupiers, which are likely to attract companies from neighbouring sectors.

Inner Paris has not experienced the same dynamism. Take-up there amounts to 366,000 sq m since the beginning of 2020, representing 36% of all volumes let or sold to occupiers in the Greater Paris Region, compared with 39% at the same time in 2019 and a sharp 44% decrease year-on-year. The biggest falls were in Paris South and Paris CBD (-50% and -47%). This was due to a very small number of large transactions and a particularly low volume of medium-sized leases. In the CBD, this decrease was undoubtedly accentuated by the decision of certain occupiers, seeking centrality and flexibility, to favour coworking spaces. However, activity could rebound over the coming months as a result of a greater supply and a rebalancing of the balance of power between landlords and occupiers.

Letting volumes also remain very low in the Western Crescent and in the Inner Suburbs. At the end of the third quarter, take-up was down 48% and 66% respectively year-on-year. In the Inner Suburbs, only three transactions over 5,000 sq m have been signed since the beginning of 2020. All three involved buildings in the Inner Northern Suburbs, such as the recent letting to VERSPIEREN of nearly 6,000 sq m in "#Curve" in Saint-Denis.

Geographic breakdown of take-up in the Greater Paris Region
By volume



Source: Knight Frank

SUPPLY: MARKET SHIFT

Supply volume continued to grow in the 3rd quarter of 2020, with 3.25 million sq m immediately available as at 1st October in the Greater Paris Region. The increase was 9% over the quarter and 17% compared with the same period in 2019. It is due both to the sharp slowdown in letting activity and the acceleration in deliveries of new/redeveloped projects, some of which should have been completed in the 2nd quarter but were delayed due to lockdown. A total of 16 buildings of more than 5,000 sq m were delivered in the 3rd quarter of 2020 for a total available volume of 150,000 sq m. In Q4, 26 deliveries are expected for a total of 182,000 sq m of available space, although some projects are likely to be postponed until early next year. This would be in addition to the 730,000 sq m due to be delivered in 2021 in the Greater Paris Region and currently still available.

Although we are still far from the previous high point in supply in the Greater Paris Region (approximately 4 million sq m between 2013 and 2015), the increase is significant and is expected to further increase between now and the end of 2020. For the time being, the vacancy rate stands at 5.9% (compared to 5% on 1st January) and remains relatively low. However, the change in the situation is already perceptible, as the market had been undersupplied for several months. This is all the more the case as we are witnessing a parallel boom in the "grey" market, which consists of an increasing number of areas being sublet by companies.

Comprised between 3.1 and 18.8%, the highest vacancy rates are in the Péri-Défense and Inner Suburb areas. In La Défense, the vacancy rate rose from 5.6% to 7.2% in one quarter due, in particular, to the delivery of the "Alto" tower.

Other projects will be completed by the end of 2020 ("Trinity", "Curve", "Akora", etc.), before other large new deliveries in 2021 ("Landscape", etc.). La Défense's vacancy rate will therefore rise above 10%, which has not been seen since 2015.

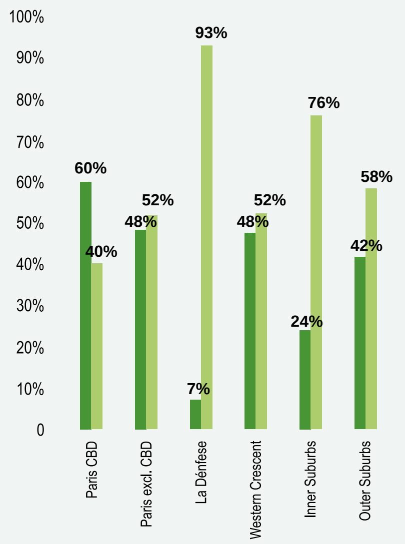
In Inner Paris, supply remains much more limited, particularly in the CBD where the vacancy rate is still very low (3%) and where the major redevelopment projects to be delivered by the end of the year are already pre-let. However, Paris has not been spared by the increase in supply. As such, supply volume has increased by 112% since the beginning of 2020, while in addition to the "classic" options are those offered by coworking operators, who are much more present in the capital than in the suburbs.

LIMITED IMPACT ON RENTS FOR THE TIME BEING

The change in prime rents in the Greater Paris Region does not yet reflect the impact of the Covid-19 pandemic. In the CBD, the prime rent thus stands at €910/sq m/year, an increase of 1% year-on-year linked to several leases signed with finance and consulting companies. Elsewhere, the trend is more towards a stabilisation of headline rents, with the correction playing more on an increase in rental incentives granted by landlords.

Pre-letting rate

By sector, in the Greater Paris Region between 2020 and 2022 (> 5,000 sq m)



Source : Knight Frank

The average rent is €410/sq m/year in the Greater Paris Region, up 1% year-on-year and down 1% quarter-on-quarter. The coming months should see a sharper drop in the office submarkets combining a decrease in demand and an acceleration in the increase in available supply.

Change in available supply volume

In the Greater Paris Region

Source: Knight Frank

THE INVESTMENT MARKET

34% DROP IN OFFICE INVESTMENT VOLUMES

After the sharp 38% drop recorded between the 1st and 2nd quarters of 2020, the sums invested in the French corporate real estate market, all types of assets combined (offices, retail and industrial premises), have increased slightly over the last three months. €4.7 billion was invested in France in the 3rd quarter of 2020, up 7% compared with the previous quarter. This increase cannot hide the magnitude of the impact of the health crisis, since just over €9 billion were invested in the 3rd quarter of 2019.

The amounts invested in France since the beginning of 2020 now stand at €16.2 billion compared to €22.1 billion at the same time last year. The decrease of 27% must be qualified by the exceptional nature of 2019. As such, the 2020 result corresponds for the time being to the level seen at the same period in 2018 and is even 19% higher than the ten-year average.

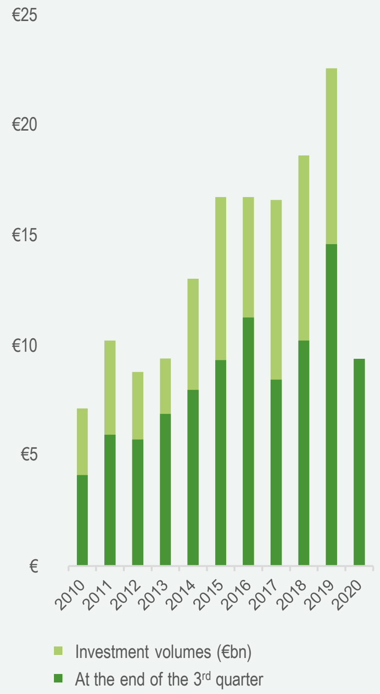
Offices show the biggest drop. With €11 billion invested in France in this market category since January, the decrease is 34% year-on-year. The drop is most marked in the Greater Paris Region where €9.4 billion has been invested in offices since the beginning of 2020, a 36% decrease year-on-year, compared with a 20% decrease in the regions. However, the Greater Paris Region obviously continues to concentrate the vast majority of the amounts invested in offices in France (85% compared with 88% at the end of the 3rd quarter of 2019).

FEWER MEGA-DEALS

In 2019, the Greater Paris Region office market benefited from a high number of very large transactions ("Le Lumière" in Paris, the "Majunga" tower in La Défense, "Crystal Park" in Neuilly, etc.). Since the beginning of 2020 mega-deals have played a less significant role, even if the number of transactions over €100 million remains relatively high (32 in 2020, compared to 38 in the same period in 2019, but 33 in the first nine months of 2018).

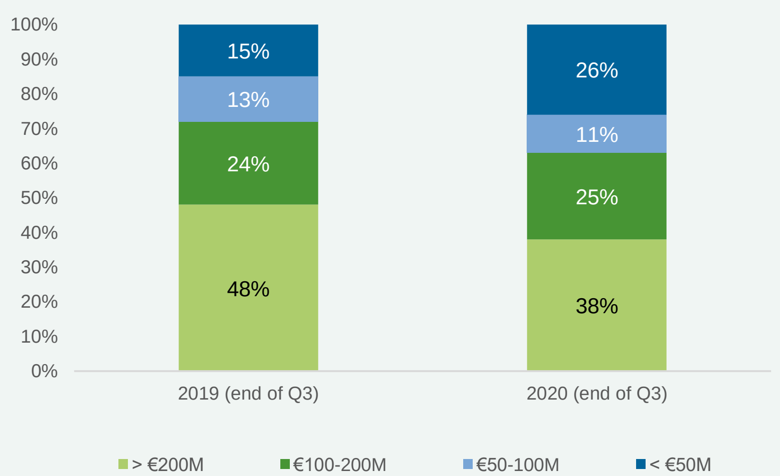
The decrease is much greater in terms of the total number of transactions of all sizes (143 compared with 190 last year), or the number of transactions of intermediate size, those between 50 and €100 million (15 compared with 27 last year and 26 for the same period in 2018).

Office investment volumes
In the Greater Paris Region, in €bn



Source: Knight Frank

Breakdown of office investment volumes by volume category
In the Greater Paris Region



Source: Knight Frank

CLEAR DOMINANCE OF THE FRENCH

French investors accounted for the vast majority of office acquisitions in Q3 2020. As we anticipated at the start of the Covid-19 pandemic, their share has been growing steadily from 50% of total office investment in Paris and the Greater Paris Region in the 1st quarter of 2020 to 58% in the 2nd quarter and 60% at the end of the 3rd quarter. This increase is notably attributable to SCPI and OPCI funds, who account for 31% of the amounts invested since the beginning of the year and who are behind several of the major transactions of the last few months. It should be noted that the sales have mainly been undertaken by foreign players, such as PRIMONIAL REIM's purchase of 3 avenue Hoche in the 8th arrondissement of Paris from the NEUFLIZE bank or HEMISPHERE's sale to AMUNDI of "Tangram" in Malakoff.

Foreign investors are much less present for acquisitions. They account for 45% of the amounts invested in transactions of more than €100 million (compared to 54% at the same time in 2019), and 40% across the board (compared to 51% a year ago). But while the current context is less favourable due to the uncertainty and travel restrictions related to the health crisis, certain nationalities continue to stand out. This is the case of the Germans, who were behind several large transactions in Paris in the 3rd quarter, including the purchase by DWS of "Toko" in the 17th district and the purchase of the "Sainte-Cécile" building by DEKA in the 9th district. On the other hand, the Americans and the British, who had been very active at the beginning of the year, have completed a much smaller number of transactions since the lockdown.

These investors are traditionally very active in the core + and value-added segments. Tighter financing conditions and the downturn in the lettings market are therefore leading them to adopt a wait-and-see attitude for the time being, even though they will complete a few significant transactions in the 4th quarter. Finally, the South Koreans remain the major absentees from the Greater Paris Region market, having invested more than €3.3 billion over the whole of 2019 and completed several iconic transactions in Paris ("Le Lumière") and La Défense ("Majunga" and "EQHO" towers, etc.).

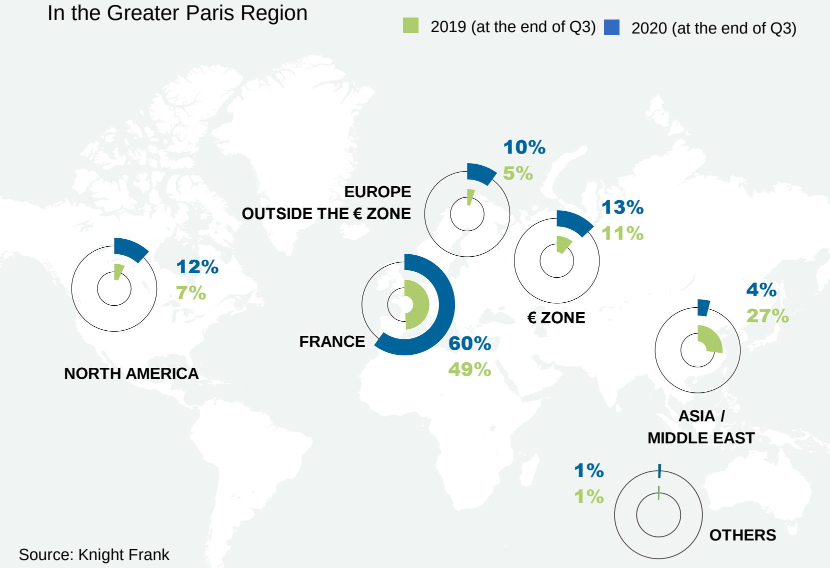
A LOST YEAR FOR LA DÉFENSE ?

In contrast to 2019, no transactions have been recorded since January in the business district. 2020 could even be a lost year for La Défense, which would be a first. Other major office hubs in the west of the Greater Paris Region have seen sharp year-on-year decreases, such as La Péri-Défense (-31%) and Neuilly-Levallois (-80%).

On the other hand, the Southern Loop is proving to be incredibly popular. In this sector with solid fundamentals and where the future supply remains very limited, investment volumes stand at €1.8 billion compared to less than €300 million a year ago. Five major transactions were completed in 2020, including four in the 3rd quarter ("Citylights 1 and 3" in Boulogne acquired by ALLIANZ and buildings 3, 4 and 5 of "M Campus" in Meudon, sold to PRIMONIAL REIM, etc.).

In Paris, nearly €4.6 billion have been invested since January (of which 46% in the CBD). This represents a 26% decrease compared with last year, which saw the completion of two mega deals worth more than €1 billion ("Le Lumière" in the 12th district and the "Texas" portfolio). However, the number of transactions in excess of €100 million increased to 16 from 11 at the end of the 3rd quarter of 2019. Finally, the Inner Suburbs markets also saw a sharp drop in activity, even though core assets which are well let and have very good access continue to attract investor interest.

Breakdown of office investment volumes by nationality
In the Greater Paris Region



Source: Knight Frank

ALL FOR CORE?

Core assets represent the majority of assets sold since the beginning of 2020, which is hardly surprising given the current context. Indeed, questions related to the health crisis (economic impact, distancing measures, the rise of remote working, etc.) are fuelling investor caution. Having significant liquidities to invest, investors are nevertheless more selective than genuinely cautious. They therefore favour quality buildings, secured on long leases and occupied by strong tenants, such as the sale to LA FRANÇAISE of 22,000 sq m let to SAFRAN in Malakoff in the 3rd quarter, or the purchase of "Antarès" in Boulogne by CNP.

Nevertheless, the sales of the last few months do not only concern core assets. The latter have even seen their share decrease from one quarter to the next (from 68% to 60%) due to the completion of a few major sales of vacant assets, partially vacant assets or those with short-term leases (sale to BNP PARIBAS REIM of Austerlitz 2 in the 13th, etc.).

Such transactions illustrate investor confidence, provided that the properties to be acquired are located in established office sectors, or in areas where future supply remains contained enough to avoid too sharp a correction in rental values. The context is, of course, more difficult for empty assets in less liquid sectors, those that are less well connected to public transport and where large deliveries of new/redeveloped projects are expected.

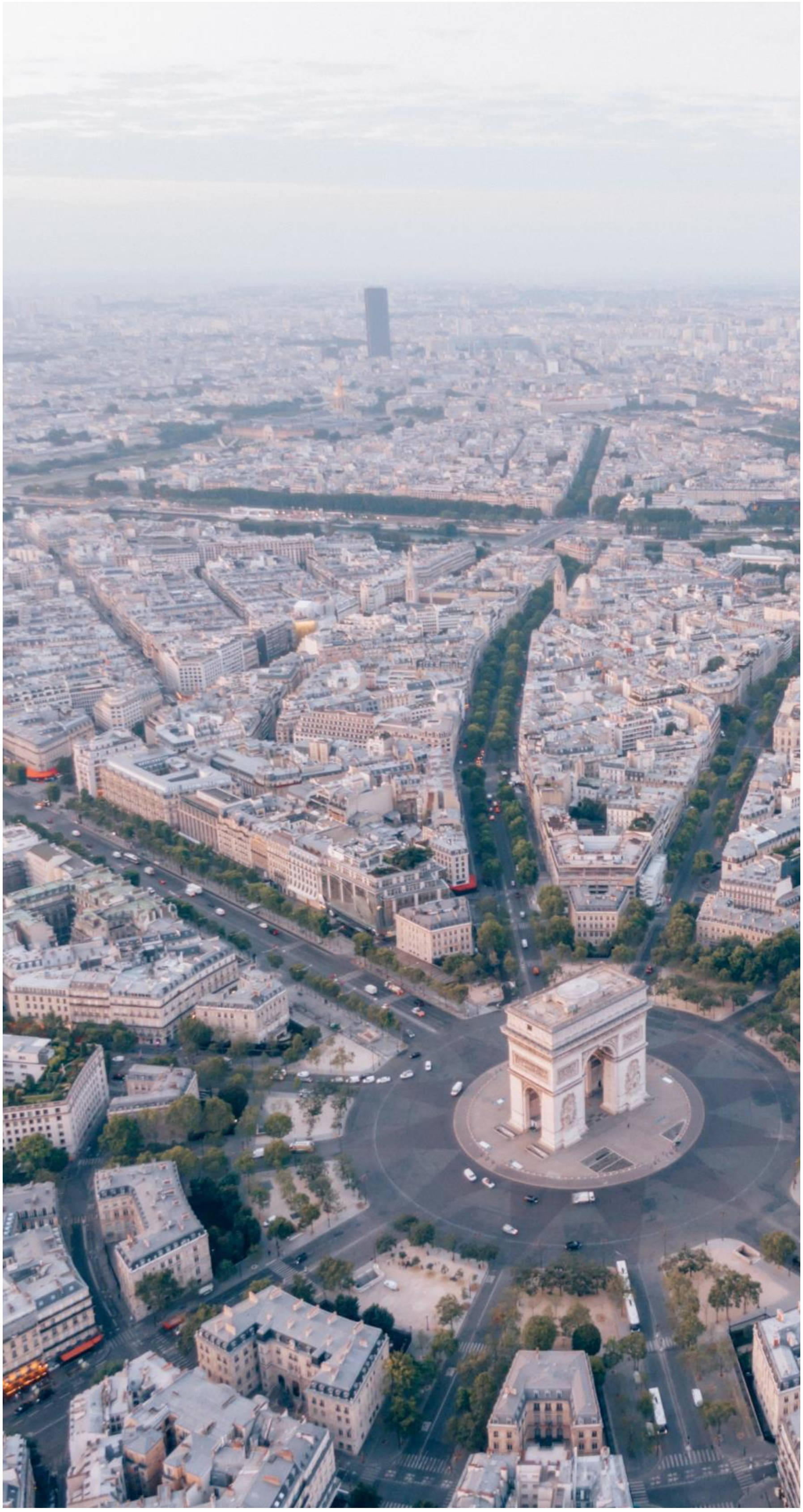
This market segmentation is reflected in wider yield gaps, whereas the trend was towards a tightening before the health crisis broke out. In fact, the upward correction is becoming more pronounced for "risky" assets, while discounts remain fairly limited for core and core + assets for the time being. The polarisation of investor demand on assets considered to be the safest is even reflected in downward pressure on yields in several office sectors, such as the Southern Loop, where yields are now between 3.25% and 3.50% in Boulogne-Billancourt (-25 to -50 basis points in one year).

Range of prime office yields
In the Greater Paris Region at the end of the 3rd quarter 2020

Source: Knight Frank

Based on the amounts invested since 1st January and the transactions currently being completed, the volume of investment in offices in the Greater Paris Region is likely to exceed €15 billion for 2020 as a whole. This would represent a drop of more than 30% compared with the historical performance seen in 2019, but an increase of around 10% compared with the ten-year average.

Admittedly, uncertainty remains high, fuelled by the recent upsurge in the number of infections. However, there is no real fear that the market will come to a standstill. Low interest rates and abundant liquidity to be invested are helping to contain the impact of the pandemic for the time being, despite the tightening of financing conditions and the deterioration of rental markets. In addition, the high office rent collection rates (generally between 85% and 100%), the return of employees to their place of work, which is higher in France than in other countries, and the efforts made to improve the value in use of buildings are all factors that reassure investors.



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