

Spotlight Q4 2022

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SPOTLIGHT
Savills Research

Investment in France



Commercial real estate investment market trends and outlook

Highlights

1. Activity levels in the French commercial real estate investment market remained high in 2022, with an investment volume of almost €28 billion. However, the pace of activity was patchy, with a very sharp slowdown observed at the end of the year.
2. The French market has never been so diversified in terms of asset classes. For the first time, offices accounted for less than half of the volumes invested in France (49%).
3. Retail asset performance was remarkable, but inflated by a few unrepresentative mega-deals. Only the retail park segment now has real market depth.
4. Despite the questions arising from macroeconomic changes, the integration of environmental constraints, and ESG approaches in building lifecycle management, investors continue to be attracted to office assets to develop a “manage-to-Core” strategy.
5. Regional areas have continued to achieve growing investment volumes thanks to their many advantages such as diversity of assets, the resilience of the rental market for quality buildings, low rental volatility, smaller asset size and higher yields than in the Ile-de-France (Paris) region.
6. The structure of yields is changing, with accelerated decompression in the fourth quarter of 2022. For Core offices, the gap between yields has widened. Previously between 3.00 and 4.00%, yields now range from 3.50/3.75 to 6.00% in Ile-de-France, due to more stringent criteria for the category.
7. These current adjustments point to a more resilient French market in the face of the economic downturn and, above all, an ability to rebound more quickly in the short and medium term.

Economic Climate: Disruption Advisory

Although the resilience of the French economy seemed somewhat against the odds in the bleak climate of 2022, with activity up 2.6%, the situation is clearly becoming more strained. 2023 looks set for much more of a cooldown. According to the World Bank, international growth is expected to be among the lowest of the last 30 years, and with only +0.5% anticipated for advanced economies, French GDP may only grow by as little as 0.3%. These, in any case, are the latest forecasts of the Banque de France. Clearly, France looks set to avoid the recession feared only recently, but the downturn is nonetheless severe. No recovery is likely before 2024, when a cautious 1.2% is expected.

With such weak growth anticipated, the employment situation is expected to deteriorate. Whilst the unemployment rate fell to a historic low at the end of 2022, the Banque de France anticipates a rise from the current level of 7.3% to 7.7% at the end of 2023 (as defined by the International Labour Office). The upturn would be limited but would bring a halt to two years of continuous decline.

Slow growth is expected to reduce demand and therefore lead to some price moderation, particularly for raw materials and energy. France's rate of inflation fell slightly in the fourth quarter of 2022, bringing it to 5.9% year-on-year (from 6.2% in October 2022). There is no clear evidence, however, that rising inflation for the French economy, or that of its neighbours, is over. Pressure on prices has indeed spread to all goods and services. Core inflation (excluding energy and food), unlike the general price index, did not fall at the end of last year. The Banque de France is not, therefore, ruling out a spike in inflation in the first half of 2023, preceding a lull that would bring the rate of inflation back down to around 4% at the end of the year. Overall, annual inflation in 2023 should remain at a similar level to that of 2022.

This feeling of apprehension is in no way exclusive to the Banque de France. It is shared by most central banks, which have highlighted inflation as a key concern and have pulled out all the stops in an attempt to fight it. The European Central Bank, for example, raised its key interest rate by 50 basis points in December 2022 (having already increased it by 75 basis points in September, and again in October). In less than a year, the ECB's key interest rate rose by 250 basis points, increasing the interest rate on the main refinancing operations to 2.50%.

Their goal is to cool down the machine by increasing access to credit, for both individuals and businesses. It's a tricky balance, there being a risk of seizing up economies in the longer term by limiting their resilience and, for Europe, of fragmenting the eurozone – a risk that increases if sovereign bond yields inside the eurozone start to deviate too far. This is a situation that the eurozone already experienced during the sovereign debt crisis in the early 2010s, and which was particularly difficult to recover from. Between this potential danger and the immediate risk of inflation, central banks have set out their priorities. The tightening of monetary policy is therefore set to continue, in turn leading to new key interest rate hikes. When and how much? “At a pragmatic pace...” stated François Villeroy de Galhau, Governor of the Banque de France, during a hearing before the French Senate in January 2023. In other words, the future is never set in stone.

	2022	2023	2024	2025
GDP	2.6%	0.3%	1.2%	1.8%
Inflation (HICP)	6.0%	6.0%	2.5%	2.1%

Source: Banque de France, December 2022

Investment Volumes : Reasonable Performance Masks Underlying Fault Line

So close! The French commercial real estate investment market came within a hair's breadth of the €28 billion mark, a level reached only three times, and an important benchmark as it is also the average annual volume for the past decade. At the end of 2022, the French market stood at €27.8 billion.

It was also able to demonstrate its depth, since the total amount invested comprised more than 600 transactions, up 14% compared to 2021: there was no magnifying effect linked to an epiphenomenal mega-deal.

The overall volume of activity is therefore perfectly respectable from a historical point of view and remains virtually unchanged from 2021 levels. However, this snapshot taken at the end of the year is misleading.

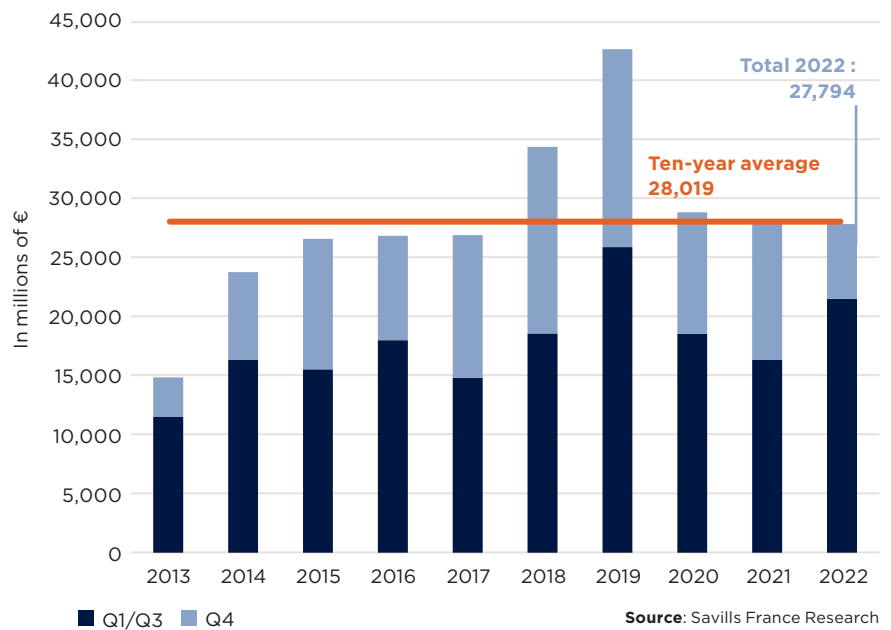
2022 was anything but homogeneous. The market held up very well throughout the first half of the year, but things deteriorated in the summer. The favourable results in the third quarter were artificially inflated by previous dynamism. In the fourth quarter, the inflexion point became clear.

While the last three months of the year are traditionally a period of strong activity, with the closing of numerous deals initiated earlier on, this was not the case last year. On the contrary, the fourth quarter saw a significant decline in the pace of activity. From October to December 2022, the volume invested in France was just €6.3 billion, the worst result for a fourth quarter since 2013, and down 45% compared to the same period in 2021.

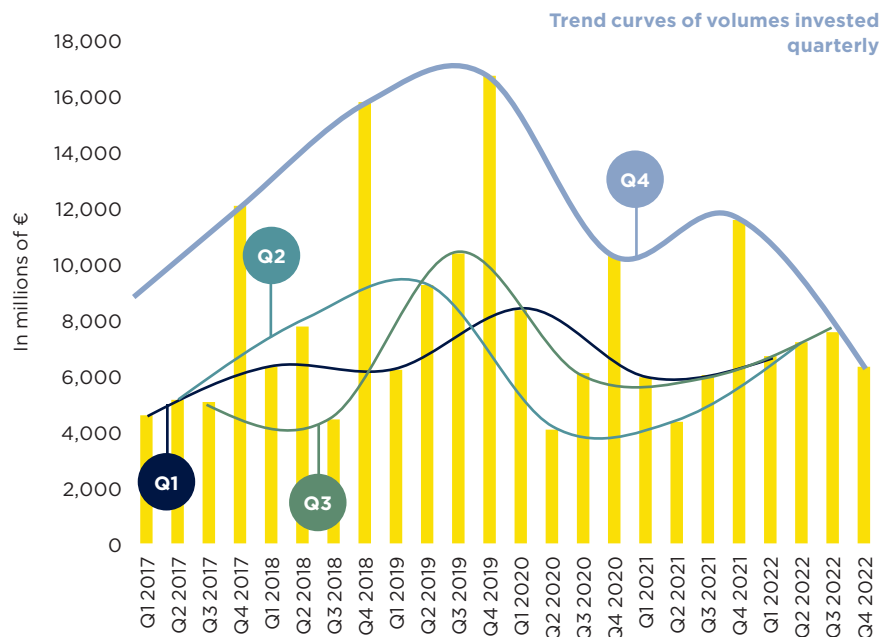
There are two contrasting positions, with buyers speculating on the downward adjustment of sale prices, and sellers showing caution and limiting the number of potential disposals. Deal completion times are getting longer and the market is becoming Malthusian.

Another notable feature of the French market in 2022, which reflects the tendency of investors to refocus their search on smaller assets, are conflicting trends in the volumes recorded in different transaction price tranches. The two ends of the prism are a perfect illustration of this:

Graph 1: Investment volumes in France



Graph 2: Quarterly investment volume trend curves





- Amounts invested through disposals of less than €20 million were up 29% in volume (the number of transactions also increased, with 317 signatures in 2022 vs. 220 in the previous year);
- On the contrary, invested amounts of more than €500 million decreased by 44% in volume. There were only two transactions (compared to four in 2021) – transactions that involved exceptional assets and therefore do not reflect a market trend.

In the middle, volumes invested in the €100-200 million range increased significantly (+25%), with 58 transactions compared with 46. This last tranche accounts for 28% of the total amounts invested, making it the largest tranche on the French market.

All other segments were down: -6% for investments between €20 million and €50 million, -22% for the €50-100 million segment, and -6% between €200 million and €500 million.

The centre of gravity of the French market slipped downwards, with the average amount per transaction falling from nearly €52 million to €45 million in the space of a year. It is important to note that this trend is not due, at least for the time being, to a decline in the metric value of the assets sold. Average transaction amounts fell as a growing number of investors turned towards smaller buildings or cheaper locations and, last but not least, alternative office assets.

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Assets Purchased : New Frontiers For All

Offices: The French investment market has never been so diversified. Office assets represented less than half of the volumes invested in France for the first time in 2022. Investors continued their efforts to reduce their exposure to offices, following occupier trends by concentrating on locations in central neighbourhoods. At the same time, they set about exploring new horizons.

Office buildings remain the main asset class, but their share for 2022 (49%) is well short of the 63% of investment volumes they account for over the whole decade. This relative decline in importance began several years ago but clearly accelerated in 2022: office buildings still made up well over half of the volumes invested in 2021 (54%).

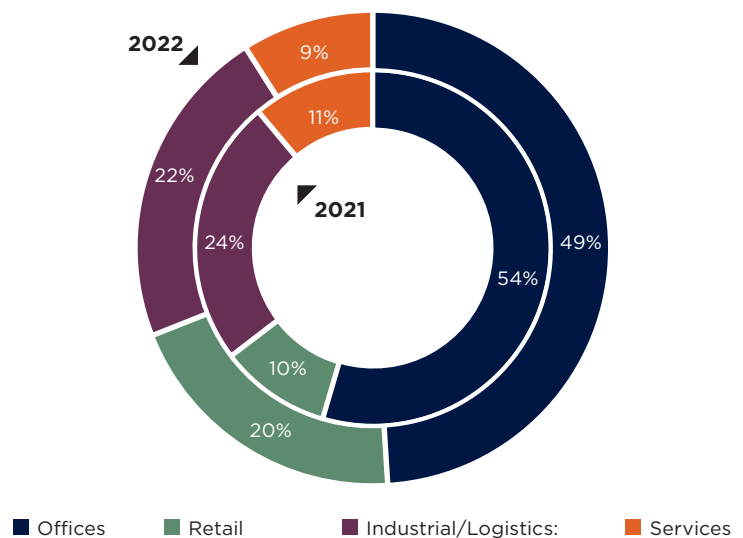
Office assets are not only down in terms of relative share. They also decreased in volume: €13.6 billion was invested through the acquisition of office space in France in 2022, compared with 15.2 billion the previous year and reflecting an 11% decline.

The blue-chip segment, Core assets, continued to dominate, accounting for 72% of the volumes invested in offices in 2022. However, buyers are being more selective before classifying a building as a Core asset. As a result, certain assets were removed from sale or potential disposals were postponed in the hope of better times ahead.

Value Add performed well, with its share of office investments growing from 15 to 18%. The resilience of this asset class seems counter-intuitive, given its potential to be affected not only by financing costs, but also by the increase in capex, the constraints imposed by the tertiary decree [décret tertiaire] and ESG and, finally, uncertainties regarding future economic activity. Boosted by strong inflows into Value Add funds, this segment has nevertheless evolved, refocusing on assets that meet occupier market conditions. Buyers' commitment also demonstrates the potential of changes in use. However, the relative success of Value Add was not enough to offset the overall decline in office investment.

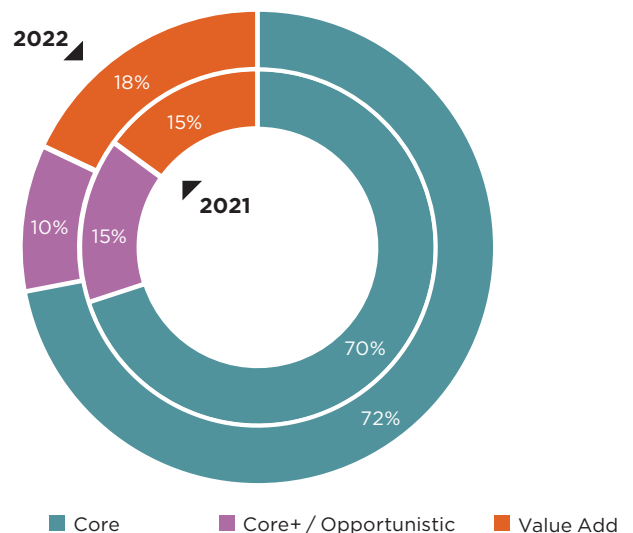
Retail: Who benefited from this erosion? The big winner is the retail asset segment. It attracted €5.6 billion in 2022, compared with less than €3 billion a year earlier, equating to an average increase of 92%. Retail saw its share of the amounts invested in France increase from 10% to 20% in the space of a year. The strong bounce-back can be partly attributed to the fact that investors were reassured by brands' ability to reinvent themselves and adapt after a difficult period as well as by the resilience of domestic and tourist demand for goods and services. However, the main reason for this success is to be found elsewhere, in the decompression of the rates of return offered by

Graph 3: Breakdown of investment volumes by asset type



Source: Savills France Research

Graph 4: Breakdown of office investment volumes by risk profile



Source: Savills France Research

acquisitions of retail assets. This decompression took place much earlier than for other types of assets and therefore restored their attractiveness. The draw was all the stronger for the fact that the inflationary environment and the increase in credit costs led investors to go in search of higher yields.

Retail parks were at the heart of investment in retail assets. They surfed a wave that began a few years ago, relying on their commercial appeal to customers and brands, their competitiveness in terms of operating costs, and their unit valuations, which are typically less than €50 million (excluding the sale of portfolios) and are generally easy to finance. Retail parks thus accounted for nearly €2.1 billion, through 60 transactions. They stand out as the main category of the retail market, increasing by 50% in volume.

The other two categories of retail assets, high-street shops and shopping centres, which unlike retail parks had suffered considerably from the public health crisis, seemed to enjoy a comeback in 2022, with respective increases of 127% (€2 billion) and 136% (€1.5 billion) in investment volumes. However, these segments do not enjoy as much depth as retail parks: their success owes much to the completion of a small number of mega-deals, which involved exceptional assets and therefore are not representative. The high street retail market, for instance, was buoyed by the retail portion of the Dray portfolio and the acquisition of 144-150 avenue des Champs-Élysées, without which it would have sunk to very low levels. In fact, this market segment has become marginal when it comes to commercial assets, with the exception of demographically dynamic regional cities, particularly in the Atlantic arc, which hold considerable potential.

Industrial & logistics: Industrial and logistics assets did not repeat their performance from 2021, which saw record investment volumes. They decreased slightly from €6.7 billion to €6.2 billion in France (-7%).

However, this constitutes a solid result. The €6 billion mark has been exceeded only three times in France, and the

volumes invested in “industrial and logistics” in 2022 are the second highest ever. For the second year in a row, this asset class thus represents a considerable proportion of the French investment market (22% of volumes invested in France in 2022). Such success was certainly not an inevitability, given that several occupiers, notably warehouses, have scaled down their development in recent months.

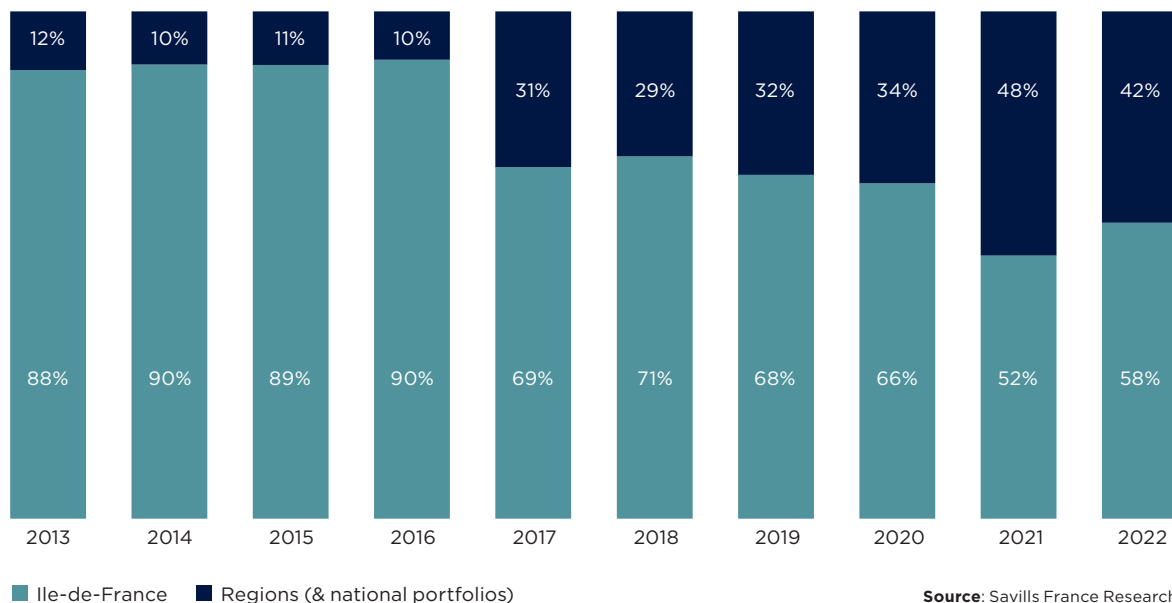
In this context, this represents a more than honourable performance. It owes much to warehouses and investors’ appetite for the sector, encouraged by the early readjustment of yields and the annuity effect generated by restrictions on new developments due to the fight against soil artificialisation. Warehouses attracted more than €4.9 billion in 2022, 80% of the volumes invested in industrial and logistics assets.

Industrial premises are still a niche market (for large, latest-generation buildings) or a sub-market that is too often reduced to a few business parks, some older than others, on the outskirts of cities. The promises to re-industrialise France and Europe offer hope for a change in this area in the short to medium term and for a new source of growth.

Services: The results for service assets (serviced residences, hotels, etc.) are much more disappointing. They were just short of the €2.5 billion mark in 2022, down 22% compared to 2021.

Unlike in previous years, this asset class was unable to count on the sale of large portfolios of serviced residences (for students or seniors) or medical assets. These were the types of transaction on which past records were built, but they were lacking in 2022. The key acquisition of a managed residence (a coliving and student housing complex in Cergy) was worth just over €100 million. In addition to the absence of large deals, this asset class suffered from a scarcity of investment opportunities, which are traditionally focused on new developments. These are suffering from the significant drop in building permits observed since the last municipal elections. The impact of the book “Les Fossoyeurs”, an

Graph 5: Geographical breakdown of investment volumes in France



Source: Savills France Research

investigation into the practices of several major operators of serviced residences for senior citizens, may also have been a source of caution among investors.

However, the hotel industry has picked up the slack. The return of domestic and international tourist traffic to very high levels during the summer of 2022 reassured buyers, who were also attracted by the particularly strong returns on investment made possible by the increase in the price of overnight stays and the upgrading of supply. As a result, hotel sales increased. Six of them exceeded €100 million. Overall, hotels accounted for €1.4 billion in 2022, 58% of the amount recorded for service assets.

Geography: 2022 will go down as a good year for the regions, meaning the whole of metropolitan France outside of the Ile-de-France (Paris) region. Their share in French investment volumes was a little lower than in 2021: falling to back to 42% in 2022 after rising to 48% in 2021. However, it remains the second-best result ever recorded for the regions.

It should be remembered that the regions' share of investment volumes only exceeded the 30% threshold for the first time in 2017. The trend therefore appears to be a lasting one, especially since, unlike what has happened regularly in recent years, the share of Ile-de-France seems to have been less affected in 2022 by the difficulty of working out the Paris region's share in the sale of national portfolios.

This success of the regions owes much to the rise of alternative assets to offices, often located outside Ile-de-France. However, it is also due to the intrinsic qualities of regional markets, which are very resilient for quality assets and which have low historical rental volatility. Finally, the spread with the fungible Treasury bond yield remained at higher levels than in the Ile-de-France region, which has become a major argument in a market now driven by an obsession with safeguarding yields.



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Sources of Invested Funds : Redistributing The Cards

A concentration of the market around the activity of domestic investors is often the hallmark of periods of uncertainty. This was true in 2022, with French buyers' share in total investment back to 62%, compared with 51% in 2021.

The predominance of French investors makes perfect sense in the market configuration that prevailed in 2022, with the reduction in the average size of deals, the strong interest in regional cities and the search for alternative assets. Their presence in the country and their knowledge of local specificities makes them the best placed to seize these opportunities.

They also benefited from a significant comparative advantage as, while inflows of open-ended funds for the general public remained buoyant in France in 2022, this was not the case throughout Europe. French funds therefore had significant room to manoeuvre in France, and indeed internationally.

However, this does not mean that the market has disappeared from the radar of international investors. On the contrary.

For example, the North Americans remained present, particularly in retail and logistics assets, opportunistically snapping up office buildings with a Value Add profile. The market's configuration in the fourth quarter of 2022 suggests that this trend is set to continue with, in particular, the possible

appearance of disposals initiated by banks whose financing lines are coming to an end.

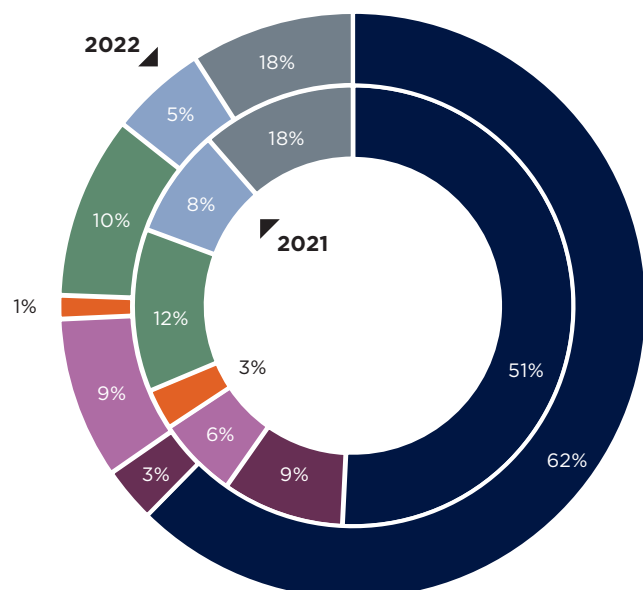
The more equity-rich and more risk-averse funds originating in the Asia-Pacific region focused on Core offices, through deals that were often concluded, or at least well on the way to being concluded, in the first half of the year. They were also very active in logistics, driven by players such as GLP, Mastern and Macquarie.

Finally, UK investors enjoyed a surge in 2022, with a market share increasing from 6 to 9%. This presence was driven by high-value acquisitions such as the Sequana tower in Issy-les-Moulineaux or "2 place de Rio de Janeiro" in the Paris CBD. However, investors from the United Kingdom did not limit themselves to these few mega deals. In reality, they got involved in all types of assets, locations and risk profiles, demonstrating an individualisation of investment strategies and their willingness to seize all opportunities that arise.

Graph 6: Sources of funds invested in France



Source: Savills France Research



Yields : A New Hierarchy Emerges

The disruption we mentioned in the investment market in the fourth quarter is illustrated perfectly by the change in rates of return. Just like easy money and zero or negative interest rates, yield compression became a thing of the past.

The rise in Prime rates, which began in the first half of 2022 for industrial and logistics buildings, spread to other asset classes and increased with a marked acceleration at the end of the year. It was encouraged by the surge in the 5-year swap rate, which, having remained in negative territory or close to zero for several years, ended 2022 at around 3.00%.

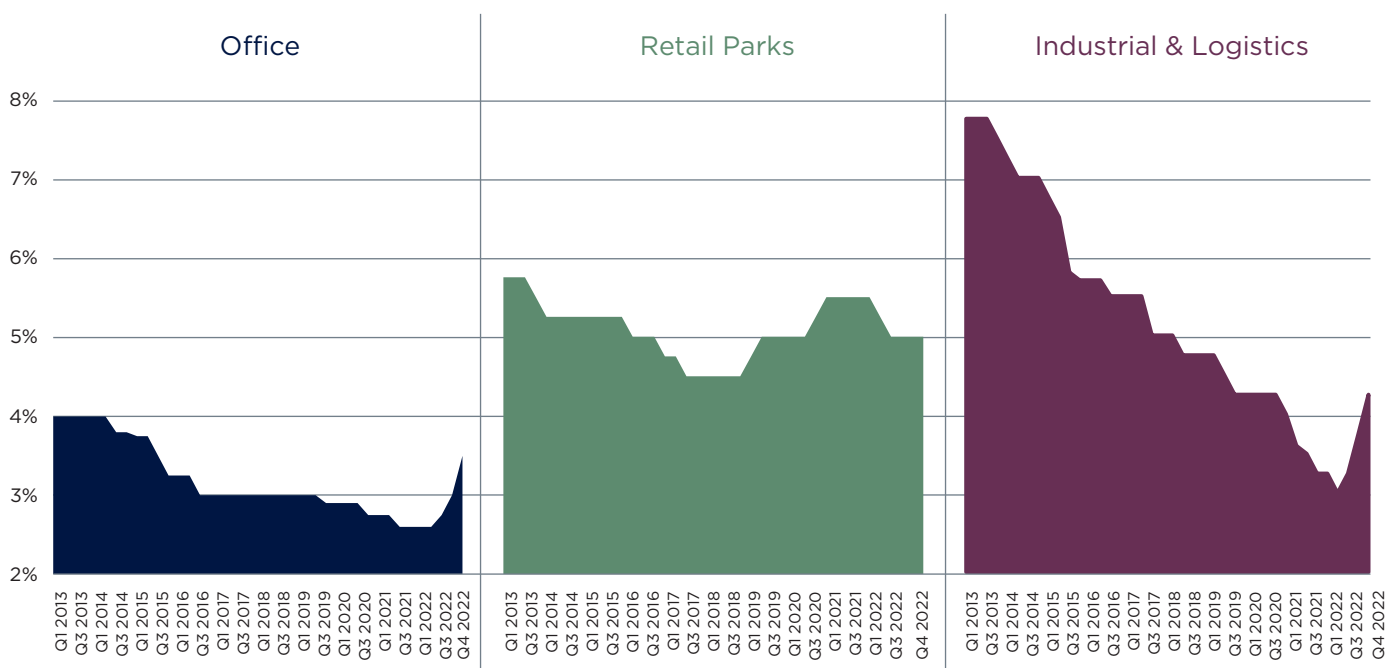
The Prime office rate in the Paris CBD, which serves as a standard for the investment market, gained around 90 basis points in one year and stood at a minimum of 3.50% at the end of the fourth quarter of 2022 (barring exceptions related to the size or rental potential of the asset). Outside of the CBD, the Prime in Paris rate rose by 75 to 100 basis points depending on the sector. In our view, the increase is even stronger outside Paris, reaching 100 basis points in La Défense (now 5.25%) and ranging between 100 and 175 points in the western suburbs and between 125 and 200 points in the three departments immediately adjacent to the capital.

The regions were not spared by this phenomenon, though it is less advanced there than in Ile-de-France. For example, the Prime rate stood at 3.80% in Lyon, up 40 basis points year-on-year.

Such a rise is by no means irrational, as it just about allows the real estate sub-fund to maintain a slight advantage over bond investments. However, the spread narrowed to 90 basis points at the end of December 2022, well below its ten-year average (235bp). It was still 257 basis points a year ago.

For Core Plus or Value Add office assets, risk is assessed and remunerated on a case-by-case basis, with increasing porosity between the two categories.

Graph 7: Change in Prime yields in France by asset type



Source: Savills France Research

Investors' approach is very much based on recalculating risks and rate mathematics, taking into account the obsolescence and sustainability of the asset, the economic fundamentals and the potential for conversion. As a growing number of questions arise surrounding the surging levels and sustainability of rents, the metric value of buildings is once again becoming an important criterion, particularly for assets leased at high prices. The result is increasing heterogeneity in valuations and a fragmentation of yields, which only accelerated in 2022.

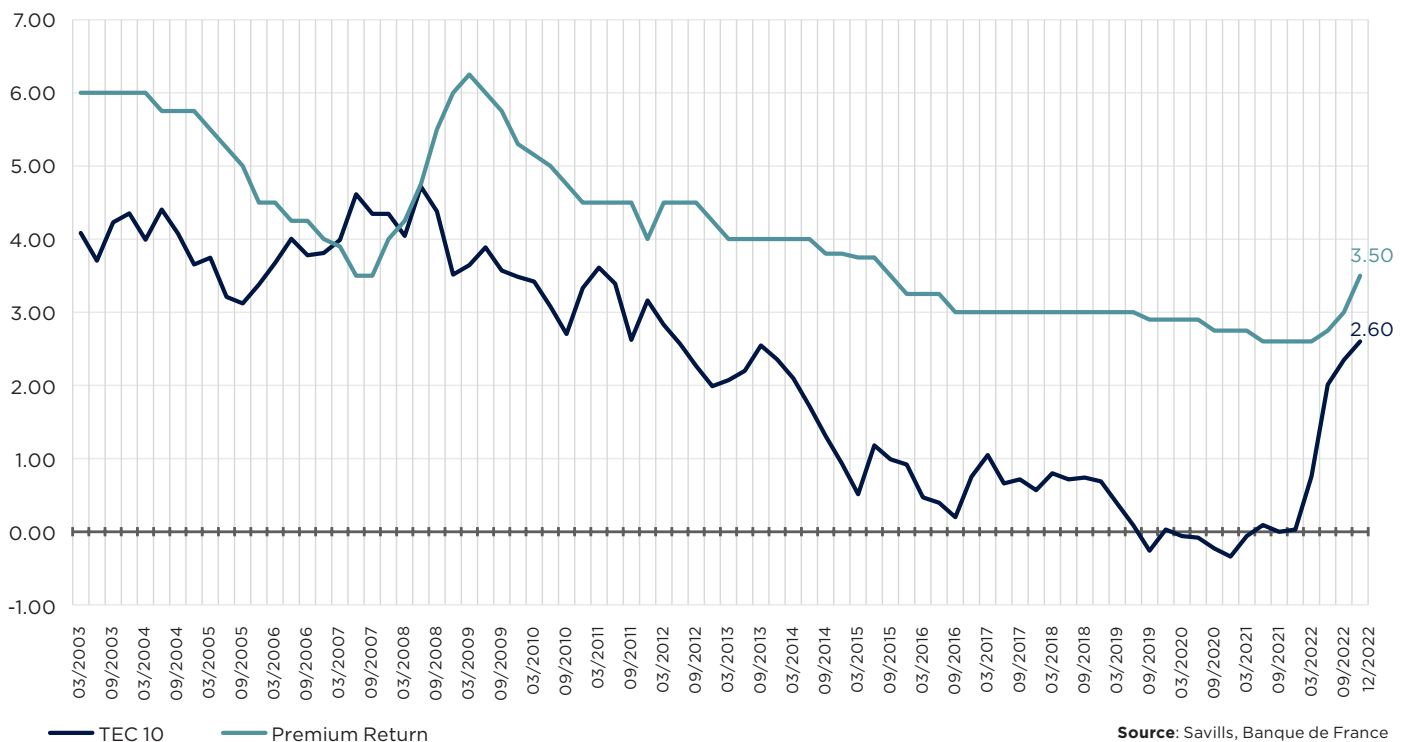
Outside the office sub-fund, yields also rose.

This started earlier for industrial and logistics assets. At the end of 2022, the Prime rate was 4.25% for Class A warehouses in the Ile-de-France region, up 100 basis points year on year. Outside the Paris region, Prime rates fluctuate from 4.45% in the Hauts-de-France region to 4.95% on the Mediterranean, near Marseille. In Auvergne-Rhône-Alpes, they are somewhere in the middle (4.60%).

For retail assets, the yield compression for the best shopping centres, which began to take shape in mid-2022 due to increased investment volumes, was short lived. The benchmark rate for these assets increased at the end of 2022 to 5.25% (+25 basis points year on year). The Prime rate for high street retailing in Paris also gained 25 basis points, rising to 3.25%.

The success of retail parks makes them the exception to the rule. The Prime rate for these assets was stable throughout 2022, remaining at 5.00%. At most, the past year has put a halt to the compression trend observed in the second half of 2021, in a world that is so different from the one prevailing today. It should be said that at the time, the comparative advantage provided by retail parks was more than significant after the rise in yields observed between 2018 and 2020.

Graph 8: Comparative change in the 10-year fungible Treasury bond yield and the Prime office yield in France



Source: Savills, Banque de France

Outlook : Doom & Gloom ?

Although recession is likely to be avoided in France and Europe, the economic outlook for 2023 is not rosy. French growth is expected to be limited to 0.3%. The World Bank now expects global growth of just 1.7%, one of the lowest levels in 30 years. But, beyond this observation, what is most noticeable is the rise of ambient pessimism. Six months ago, for example, the World Bank was predicting 3% growth... The deterioration in the perception of the economic environment among decision makers has been clear for all to see. They were expecting the start of 2023 to be all “Doom and Gloom”, as the Rolling Stones once sang... So much so that they have probably painted too bleak a picture.

It is true that central bank announcements do not help. They point to a continuation, at least for a few months, of monetary policy tightening and a higher interest rates. However, positive factors are emerging. Job creation remains strong, companies are maintaining their willingness to invest and to hire, and the structure of office consumption (oriented towards Prime buildings in the

best locations) reflects a rental market that is not only driven by a desire to cut costs. Finally, real estate investment is becoming increasingly diversified and exploring the charms of hybridisation and change of use.

Demand: In addition to asset repricing, these factors – if they are confirmed in the short term – should reassure and encourage investors’ demand for real estate. This is all the more true for the fact that many of them remain equity-rich, partially immunising the market from the effects of rising credit costs. For example, in October 2022, net inflows from funds monitored by Asspim amounted to €11.6 billion year-to-date (including €3.4 billion in the third quarter), up 48% year-on-year. The figures for the fourth quarter of 2022 are not yet official, but they should be favourable in terms of inflows from individuals.

For their part, private companies, which benefit from more flexible financing conditions, will be able to seek to take advantage of the new opportunities offered

by real estate.

Even if buyers are more cautious and selective, the driver of demand should therefore remain in effect, particularly for Core assets or for assets allowing a “manage-to-core” or “develop-to-core” strategy, which continues to be popular with investors.

However, we are talking about demand for real estate assets, not necessarily demand for French real estate assets... Investors’ gaze extends beyond France’s borders and they will not neglect to compare the profitability offered by other European markets, particularly in the eurozone.

Demand will therefore remain active, though it will, of course, be lower than in 2022, if only because institutional investors are being offered more profitable alternative investments (starting with certain bonds) and because a portion of the available equity can also be used for transactions to maximise the value of existing assets or refinance maturing debt.



Supply: Over the past few months, supply has generally been contained by sellers, who are wary of selling under unfavourable conditions. This was one of the factors behind the decline in investment volume in the fourth quarter and could ease up in 2023.

Firstly, because investors are faced with the maturing of their debt, contracted when the 5-year swap rate was no higher than 0.5%. Now that the 5-year swap rate is around 3.0%, some of these owners will be able to decide to proceed with switches. These switches will involve Core assets if refinancing needs are high and require rapid cash inflows.

Secondly, because the integration of environmental standards and ESG processes is having an impact on the real estate market. Take, for example, the 54 SRI-certified retail real estate funds which made up 44% of inflows in the third quarter of 2022 and accounted for 45% of capitalisation.

All of these owners will, if they have not already done so, have to carry out asset reviews leading to the adoption of a strategy for each of the assets they hold, particularly

those that do not meet ESG criteria. This strategy could involve bringing the asset into compliance with standards and maximising its value (through restructuring or a change in use), sale or, finally, temporary withdrawal from the market (a short-term and limited solution). The rise of ESG criteria will therefore inevitably lead to an increase in asset disposals to be revalued.

Prices and yields: Active demand, albeit generally lower than in 2022, and an increase in supply... These factors, combined with the continued tightening of monetary policies and its repercussions on the 5-year swap and bond yields, are creating the conditions for a drop in market values and further decompression of yields.

How far will this go? Unlike what has often happened in the past, the French market has been reactive and has already seen a significant increase in yields at the end of 2022, particularly in the Paris region. It is therefore likely that most of the repricing has been done, even though there are still some

adjustments to be made.

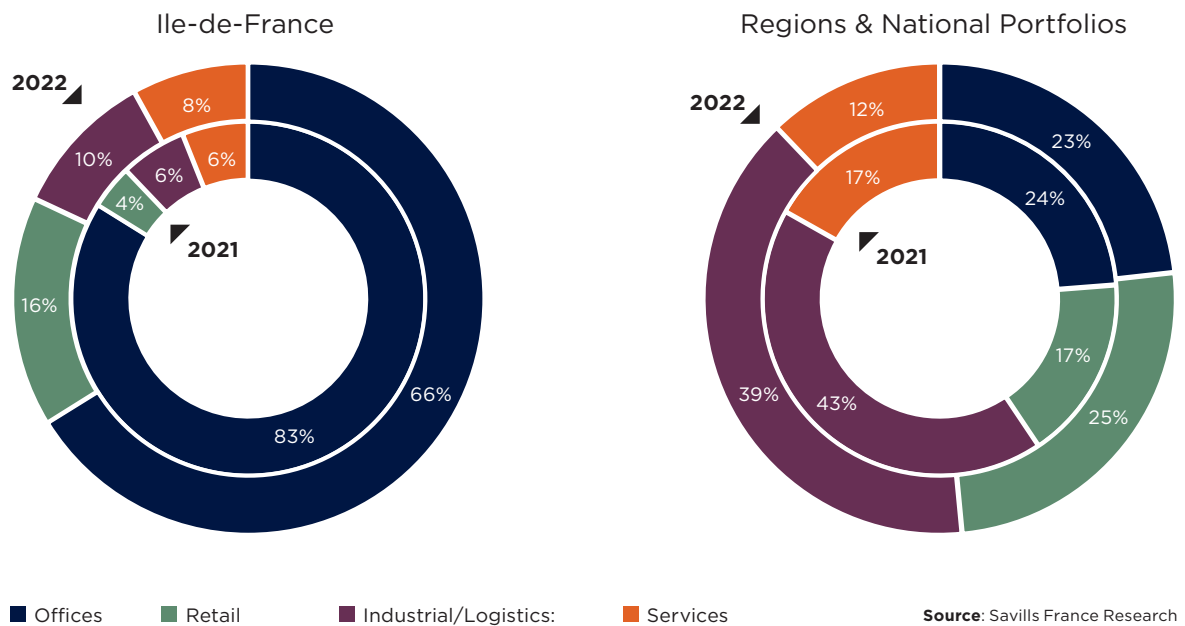
These will be stronger in the least established geographical markets. As such, the widening of the Core yield range is expected to continue, ranging from around 3.50/3.75% to at least 6.00%.

These conditions can prevent the French market from experiencing a sharp drop in investment volumes in 2023, as was the case after the subprime crisis, with a fall that lasted six years. On the contrary, we can now hope that the French market, reinforced by its lower concentration on office assets, will reach close to €20 billion. So, it's not all Doom and Gloom after all...

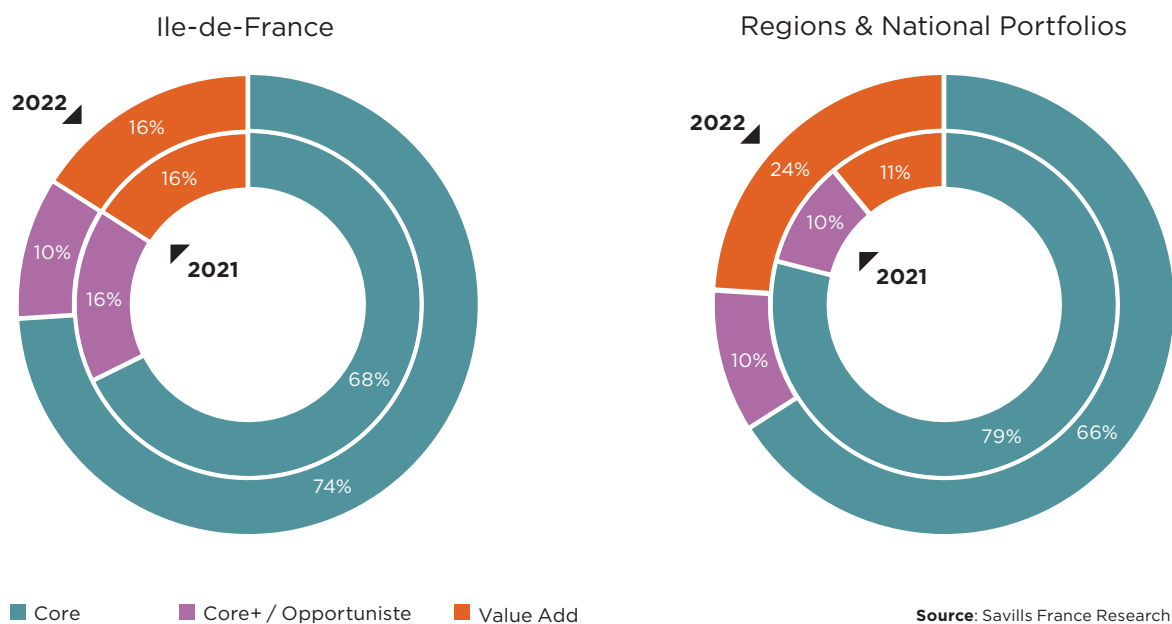


In Pictures: Ile-De-France vs Regions

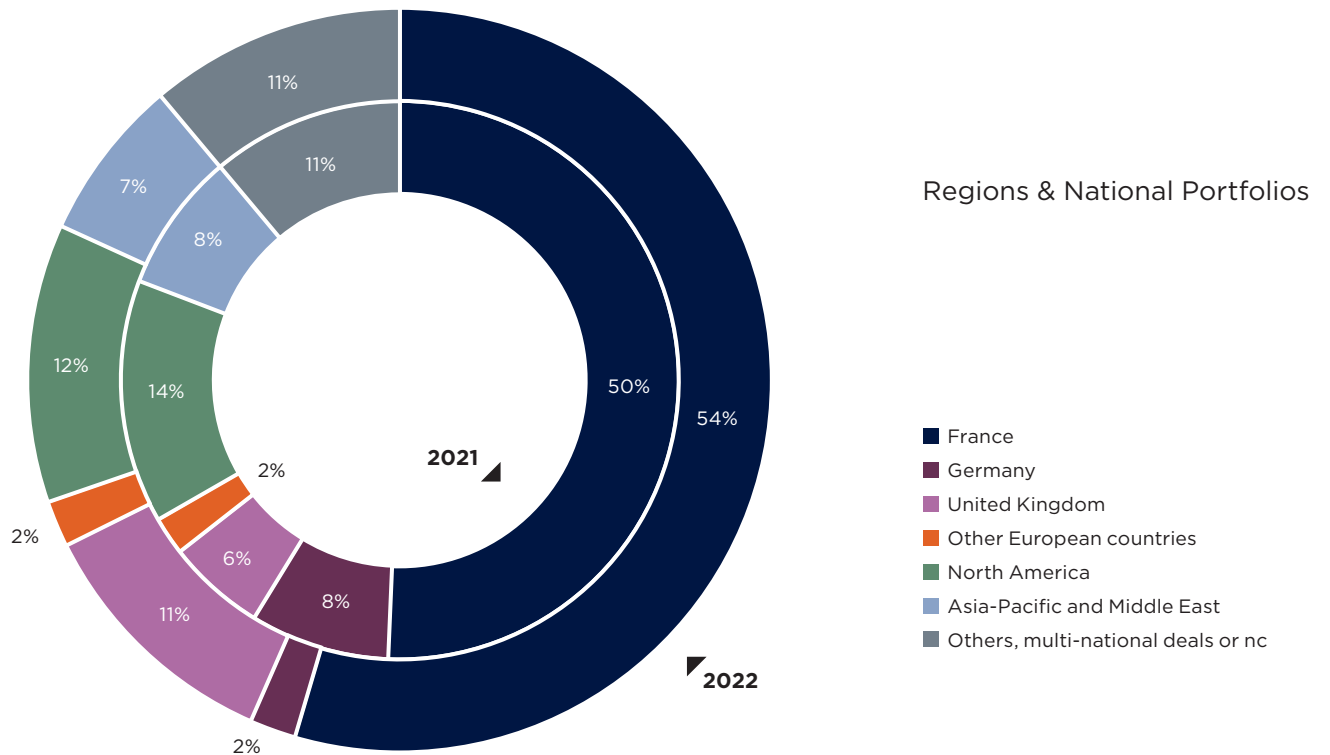
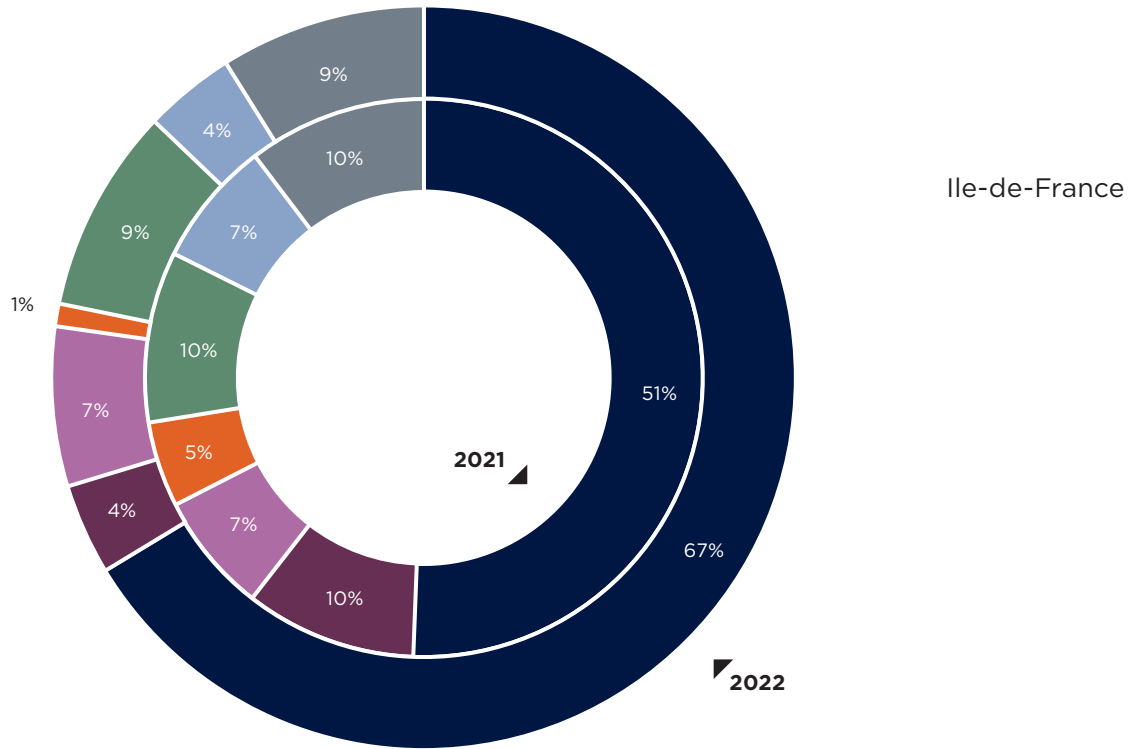
Graphs 9 & 10: Breakdown of investment volumes by asset type



Graphs 11 & 12: Breakdown of office investment volumes by risk profile



Graphs 13 & 14: Sources of invested funds



Source: Savills France Research



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