France – Q1 2020

SPOTLIGHT

Savills Research

Office Letting Market

With the economy feeling the sting of the Covid-19 crisis, what can we expect from the rest of 2020?

-5% to -8%
Forecast GDP Contraction
for France in 2020

+4,5% to +6%
Forecast GDP Growth
for France in 2021

Economic context

Into the Unknown

In the early days of social distancing and then lockdown, it seemed inevitable that the macroeconomic effects of the Covid-19 crisis would be severe. However, ever since then, experts have been continually revising upwards their estimate of its overall impact. For now, we have no forecast to offer, since any prediction is likely to be overtaken by events as France's exit strategy becomes clearer.

Deep recession in 2020 before bounce back in 2021

In early April, the Bank of France estimated that French GDP had shrunk by 6% in the first quarter of 2020. INSEE projected an economic cost of 3 GDP points per month while the lockdown remains in place, indicating a drop of 6 points after eight weeks. These estimates tally with those put forward by the Economist Intelligence Unit and the Institut Montaigne, both of which expect a 5% contraction in GDP in 2020. This assumes a loss of 12% in Q2, with the return to normality phased in gradually over the rest of the year. France is likely to be on a par with the United Kingdom, also set to lose 5% of GDP, but better off than some neighbouring economies, namely Germany (-6.8%) and Italy (-7%). The Eurozone as a whole will be harder hit than other parts of the world, with an average GDP loss of 5.9% in 2020. Across the Atlantic, it is thought that the United States will fare slightly better, dropping 2.8%. Overall, the global economy is predicted to shrink by 2.2%. Although estimates have been adjusted by a considerable margin, these figures are still very much provisional. On 19 April, for instance, some hopes were deflated when the governor of the Bank of France announced that the toll on the French economy could be as much as 8% in 2020, depending on how restrictions are lifted.

One thing, at least, is certain: the repercussions of the Covid-19 crisis will be significantly worse than what transpired in 2009, in the wake of the collapse of Lehman Brothers. Then, the cost to the Eurozone was "only" 4.1% of combined GDP; the UK economy shrunk by 4.2% and the global economy by 0.1%.

If there is a glimmer of light on the horizon, it's that the recovery expected in 2021 should be much faster than initially thought. France could see a rebound of between 4.5% (according to the Bank of France) and 6% (according to the Institut Montaigne). Many will be pinning their hopes on this scenario, which assumes that the unprecedented stabilisation measures introduced by many governments, particularly in the Eurozone, will spare us from the kind of prolonged economic torpor that followed 2009. A V-shaped recovery is still thought to be the most likely outcome, but it's a capital V, with a steep upstroke. These hopes could still be dashed if the path out of lockdown proves difficult. In this case, the V would become a U, with the recovery taking longer to gain momentum.

Tough times ahead in the labour market

At least initially, the labour market is in for a brutal shock: the International Labour Organization (ILO) estimates that 38% of the global population, or 1.25 billion people, are directly at risk of losing their jobs. In Q2 2020, the ILO expects the loss of 195 million full-time jobs, 12 million of which will be in Europe. Will this mass unemployment be a temporary adjustment to a changing context, or could it become a structural problem? Assuming that stabilisation measures are effective and the economic recovery is swift, the vast majority of job losses will be temporary, and the worst will be over after a few weeks or months.

France, for example, has put in place a massive temporary and partial unemployment scheme, signing up 9.6 million workers by 20 April. With a provisional cost of over €20 billion for three months, this will put enormous strain on the national budget. Under this scheme, salary costs will be temporarily collectivised, taking some of the burden off companies and leaving them in a stronger position to bounce back and salvage jobs. With some luck, the scheme will be a success and will help cushion the overall impact on employment and purchasing power. That said, it is important to be realistic. At the end of 2019, the unemployment rate in France stood at 8.1%, the lowest level in 11 years. We must therefore expect this progress to be set back by the events of 2020 and be prepared for the possibility of unemployment climbing to as much as 10% of the active population, at least for a while.

The Île-de-France lettings market at Q1 2020

A market with no vaccine

Following a lacklustre start to 2020, market activity came to a grinding halt in mid-March as social distancing measures kicked in, swiftly followed by full lockdown.

Take-up: emergency stop
At the end of Q1 2020, office take-up in Île-de-France stood at 340,335 sqm. Marking a year-on-year drop of 37%, this figure has, of course, been heavily weighed down by March's events, which effectively hit the pause button on the market. To give a full idea of the impact, the total take-up recorded for Q1 2020 is 35% lower than the ten-year average (526,950 sqm).

Every floorspace category has been hit by plummeting activity. What remains is still largely driven by small-scale transactions — representing 43% of the total, this segment is holding up better than the rest, with take-up down 24% y-o-y. The mid-range bracket (1,000–5,000 sqm) has fared less well; here, take-up has fallen by 41% y-o-y. It still plays a key role in the market, accounting for 33% of take-up in the Île-de-France region as a whole. It is the upper end of the scale (> 5,000 sqm) that has borne the brunt of recent events, with a sobering year-on-year decline of 47%. Just ten deals were recorded in Q1 2020, four of which were owner-occupier sales.

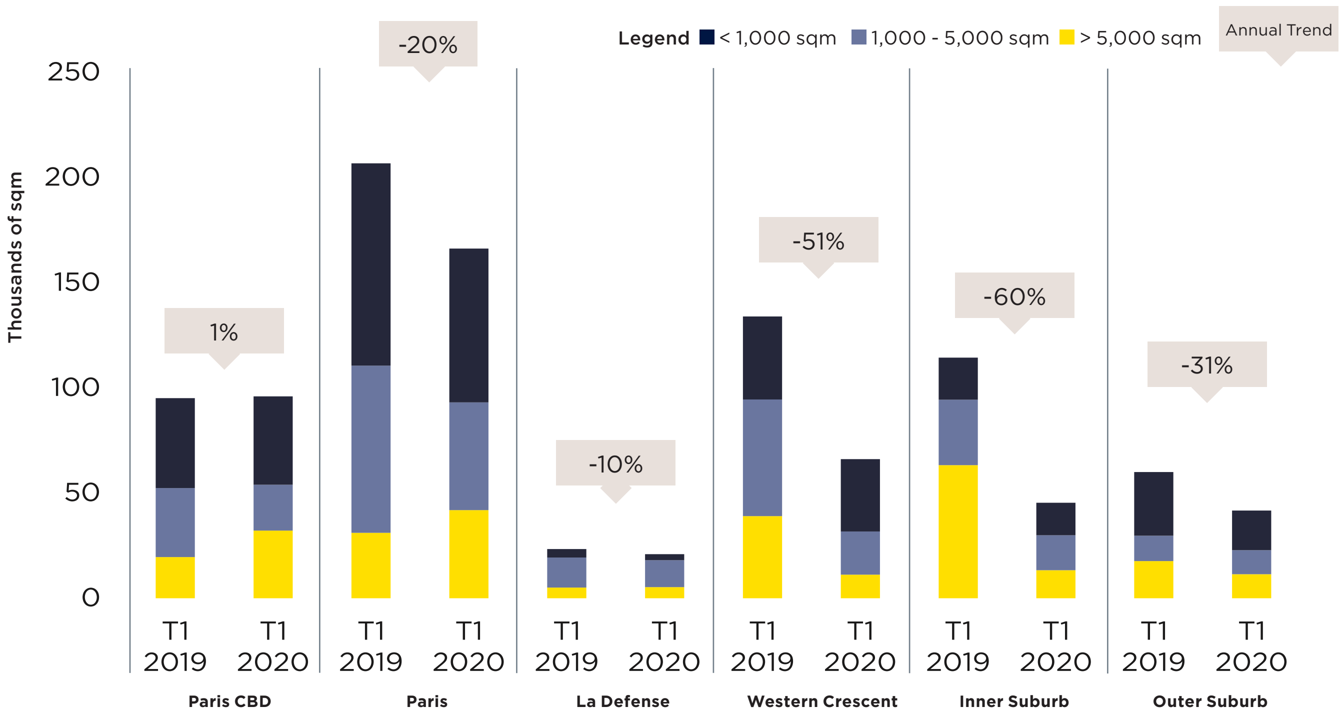
Geographically speaking, the entire Île-de-France region has seen a significant dip in activity, with the notable exception of certain Paris submarkets, where take-up has actually increased: Paris 5-6-7 has been given a 28% bump, Paris 12-13 is up 48% and Paris 18-19-20 is up 36%.

The stability of the CBD, where activity remains robust, is quite a feat given the circumstances, and owes much to three recent signings involving floorspace in excess of 5,000 sqm. Boston Consulting Group's leasing of 20,000 sqm in the L1ve building in the city's 16th arrondissement was especially helpful in this regard. These are, however, just a few specks of light in a sombre landscape — in the Paris market as a whole, take-up is down 20%.

La Défense also saw take-up fall 10% y-o-y. While La Défense appears to be outperforming the Paris average, it continues to fall well short of its potential, with only 21,000 sqm let in three months.

The Western Crescent, (down 51% y-o-y) and the Inner Suburbs (down 60%) have been hit hardest. Prior to the current crisis, the prevailing winds seemed to be blowing towards more outlying areas, but Q1 2020 put an abrupt stop to this trend. Only two transactions for floorspace of over 5,000 sqm were recorded this quarter, both for properties in the North Inner Suburb. As a result, take-up grew by 8% y-o-y — unspectacular, perhaps, but enough to lift this submarket above the rest.

Take-up by geographical area and floorspace category
Activity will continue to fall in every major Île-de-France submarket, with the exception of the Paris CBD



Sources Savills Research - Immostat

-37%
Annual decline of take-up between Q1 2019 and Q1 2020 in the Paris Region

-47%
Annual decline in transaction exceeding > 5,000 sqm in Paris Region in Q1 2020

Available supply: A hint of a rebound

After shrinking steadily for five years straight, immediate supply in Île-de-France rose slightly in the first quarter of 2020, reaching a total of 2.9 million sqm. This puts it back on a par with early 2019 (stable y-o-y, but up 7% q-o-q). Still, this uptick is proving insufficient to ease the pressure on supply: the average vacancy rate for the region as a whole is still just 5.4%, too low to guarantee free-flowing activity on the lettings market.

Furthermore, most of the increase in immediate supply is attributable to existing property. The proportion of Grade A supply remained unchanged between Q4 2019 and Q1 2020. Accounting for just 20% of available space, there is still a sizeable gap between supply and demand.

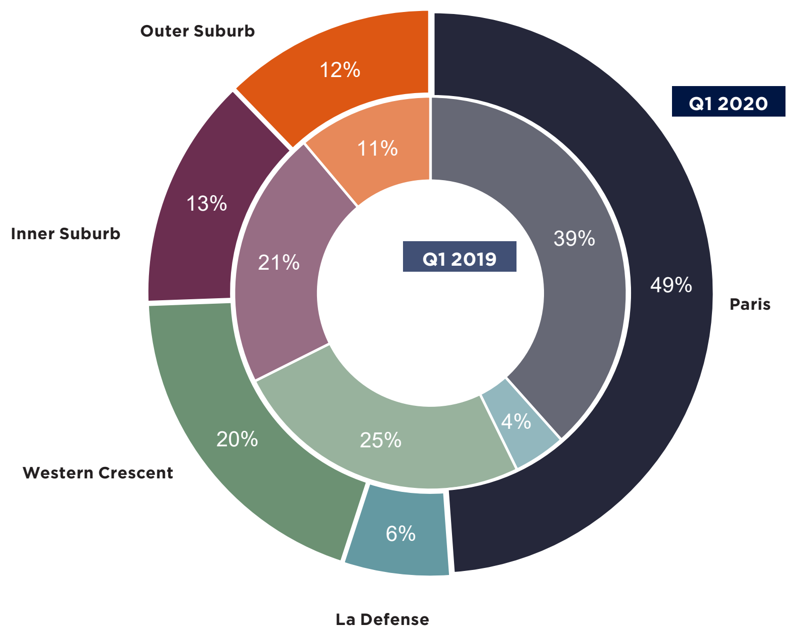
This slight rebound is not uniform across the Île-de-France region. Vacancies are rising in Paris (up 9%), La Défense (up 16%) and the Western Crescent (up 5%) but starting to dry up in the Inner and Outer Suburbs (down 12% and 4%, respectively).

Rental Prices: A seemingly upward trend, but don't be deceived

The end of 2019 saw rental growth in almost every part of Île-de-France, whether for Grade A space or existing property. As take-up held firm at a more than acceptable level and pressure mounted on immediate supply, rental prices were pushed up in every submarket, starting with the most sought-after areas.

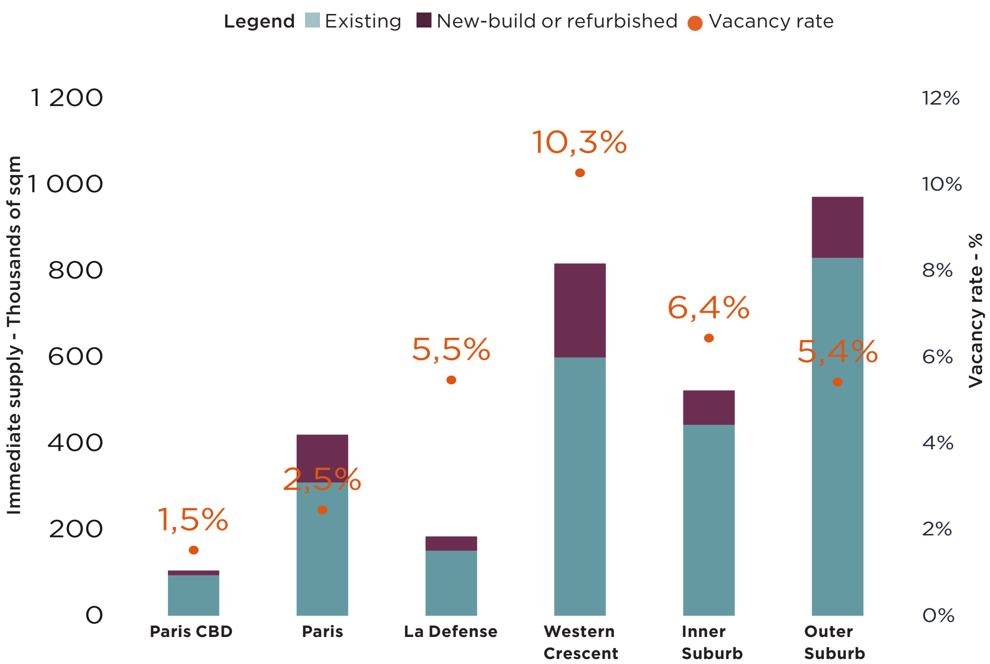
The repercussions of the Covid-19 crisis have not yet filtered through to the Q1 2020 figures, but this will clearly change as the year goes on. In Q1, rental prices rose on the back of brisk activity in January and February, the sign of a lettings market in excellent health. This trend could be seen in virtually every submarket in Île-de-France. The prime rent in the CBD, for instance, reached €870 per sqm per year, a gain of almost €20 compared with Q4 2019.

Breakdown of take-up by geographical area
Business districts offer a rare refuge



Source Savills Research - Immostat

Quality of immediate supply by geographical area
Richer pickings in the Western Crescent, in both quantitative and qualitative terms



Source Savills Research - Immostat

Outlook
Time to reshuffle the deck

Back in the pre-pandemic world, 2020 was already on track to be a fairly uninspiring year in the Île-de-France lettings market, with more muted letting activity than the year before. The ongoing drama over the reform of the French pensions system had already poured cold water on a previously upbeat market.
There is still a great deal of uncertainty about what the next few months will bring, but it is abundantly clear that activity will slow significantly.
That is not to say that there will be no deals at all — hands will be redealt and prevailing trends disrupted, but as it all settles down, the pace should start to pick up again.

Differential impacts across sectors
The Covid-19 crisis will exact a heavy toll on French companies and the domestic economy in the coming months. Two months of lockdown, synonymous with slamming the breaks on the economy, will be highly damaging in terms of performance and turnover, not to mention profitability. We can only hope that in most cases wounds will be quick to heal, thanks to the unprecedented volumes of financial aid that have been made available. The partial or temporary unemployment scheme, for instance, which covers almost half of all private-sector employees, did not exist at the time of the 2007/2008 financial crash. It must also be borne in mind that, in the short and medium term, the fall-out will vary considerably between sectors. For many, business is at a total standstill, but some companies are discovering new opportunities as habits and working patterns adapt to lockdown life.

Unsurprisingly, transport, construction, services (particularly tourism and F&B), industry and trade — anything that does not qualify as “essential to the life of the nation” — have been hit hard. Companies in these sectors will face substantial financial losses throughout the lockdown and for some time afterwards. The return to business as usual will presumably be phased in gradually; once stores and offices reopen to the public, it seems highly likely that people will remain wary, at least for a while, and will be reluctant to rush back to crowded high streets.

Some sectors, on the other hand, are not doing too badly, continuing to operate “as normal” or even enjoying an upturn in business. Telecoms companies, for instance, fall into this category — never have their services been in such high demand.

IT companies have benefited from the massive shift to home working, and the pressing need for remote solutions has opened a window of opportunity. With all “non-essential” office workers confined to their homes, companies not previously equipped for remote working have had to up their game. A great many people are currently discovering home working for the first time, planting the seeds of a longer-term shift in working practices.

Even after the restrictions are finally lifted, remote working will undoubtedly become more prevalent — partly because social distancing measures will remain in place and partly because companies are bound to double down on their efforts to join the digital age.

Furthermore, most companies will now have woken up to the threat posed by so-called ESG risks (environmental, social and governance) and the need for preparation and robust measures to ensure the resilience of their business models. That will mean calling on the services of a wide range of sectors, including crisis management, human resources, finance, law and, again, communications. There are plenty of opportunities for companies proposing solutions to mitigate these risks, from consultancies to tech start-ups to law firms.

A slump in take-up on the horizon for 2020
There is no doubt that the office lettings market in Île-de-France will suffer lasting harm from the Covid-19 crisis. The impact can already be seen in take-up figures for Q1 2020, and the return to normality is likely to be a long, slow road.

For the immediate future, demand will keep dropping and there will be far fewer lettings. A wave of corporate bankruptcies and lay-offs over the next few months is highly likely; this will have a direct impact on demand for workspace, and particularly for small and mid-sized spaces.

Major corporations, with their greater exposure to fluctuations in global trade, are not immune. While they may have a larger cash cushion, the outlook is bleak, and large companies will be thinking about scaling down their real estate strategies. Future market conditions are still very hard to predict, at least for the rest of 2020. Uncertainties with respect to public health (does ending the lockdown mean that a second wave of infections a few months down the line has been discounted?) and the economic context (fears of a deferred crisis in an overleveraged sector, repercussions of a collapse in oil prices, etc.) will heighten the sense of a fragile and volatile global economy. With the way ahead veiled in uncertainty, confidence is low, and that’s a very worrying situation for the health of the real estate sector. The main problem will be a reluctance to act until the outlook clears, resulting in an imminent glut of abandoned or postponed projects.

Taking a longer-term view, it seems inevitable that companies will be looking to make adjustments to their real estate strategies. The trends that have held sway over the Île-de-France market in recent years could be thoroughly shaken up. There are a number of factors that could affect demand for office space, both positively and negatively, and the performance of the market will depend on the equilibrium that emerges.

Before the pandemic, attracting and retaining talent was the average company’s top priority when making real estate decisions. This meant seeking out premium spaces in desirable areas,

right in the heart of the Paris city centre. A lack of high-quality options, exacerbated by fierce competition for the most prestigious spaces, inevitably pushed up rents. Now, it is likely that geographical centrality will become less of a concern for many employers. It looks like the end of the upward trend in rental prices is nigh.
Cost reduction, on the other hand, will be a big priority going forward. More and more landlords will soon be dealing with tenant requests for a rent-free period or staggered payments, although it is too early to judge the impact of these discussions.

More companies will try to make savings by renegotiating existing lease agreements; those that are able will aim to cut back their space requirements as organisational structures are reshaped and working patterns change. One conceivable outcome is a more widespread reliance on remote working; alternatively, we may see existing workspaces redesigned, or more widespread demand for flexspace solutions. Some, of course, may simply choose to relocate to an area where rents are lower.

The end of spiralling rents

As occupier demand begins to wane, the upward pressure on rents will inevitably ease, particularly in the Paris markets. However, there are forces at work on both sides of the equation: the coming months will almost certainly see a rise in vacancy rates.

Looking to 2020 and beyond, there are two main factors that will drive up available supply. The first is the large number of corporate bankruptcies looming just over the horizon. Over the next few months, immediate supply will grow as these occupiers vacate. The second is the resurgence of construction activity that began before the crisis hit. As these projects reach completion, there will be an influx of new or refurbished space, even if delivery dates need to be pushed back to make up for lost time.

Consequently, available supply, including Grade A supply, will become more plentiful (especially if there is a downturn in pre-lets). However, the overall effect will be limited: just 620,000 sqm of available supply are expected in 2020 (compared to a total stock of almost 54 million sqm) and there will be fewer projects coming up through the pipeline.
Still, the problem of undersupply, which reached critical levels before the pandemic, may very soon be resolved. Not all markets in Île-de-France will feel the same correction, but there is a good chance that the trickle-down effect will be enough to temper rental growth across the region.

In some areas, rents may even come down.
At the time of the 2008 crisis, rents for new-build property in the CBD fell by around 15%. However, the recovery was quick; by 2011, prices were climbing steadily once again, proving that a corner had been turned. There is no reason to expect things to be different this time around.
Meanwhile, it is highly likely that the government will shore up its business support measures, and these may outlast the impact on rents.

In recent years, areas such as the West Inner Suburb (beyond the CBD), Paris 3-4-10-11 and Paris 14-15 have experienced unprecedented rental growth, the outcome of a lack of options in more traditional business districts and sustained demand from emerging players such as start-ups. However, these companies may now be feeling rather more fragile, as efforts to raise capital are put on hold and cash flow problems begin to bite. Deprived of their core clientele, less traditional locations for businesses in Paris may struggle to sustain their former rents.

This is likely to be the fate of La Défense, particularly since it has a lot of new space scheduled for delivery this year. This business district is set to receive more than 30% of all new office space in the greater Paris region this year, with no pre-lets agreed at the time of writing. La Défense will soon become a hot pick for prospective tenants, raising the spectre of a period of repricing over the course of 2020.

Less central areas may benefit from a knock-on effect as occupiers seek to optimise their real estate costs. With more affordable rents, a growing public transport network and a more widespread use of remote working to compensate for a long commute to central Paris, these districts might just sail through the storm relatively unscathed. This scenario would be particularly favourable to premium properties in the Inner Suburbs.

“Although the road ahead is uncertain in the short term, companies will soon need to start assessing whether their workspaces comply with the new public health and social requirements, and start tallying the costs and financial impact of adapting them to this new context. This should help keep things moving in the market, provided that landlords are supportive”

Bertrand Renaudeau d’Arc, Head of Agency Savills France

Coworking: double or quits?

The coworking model has been one of the biggest casualties of the pandemic. Its entire philosophy rests on packing more workers into less space and encouraging a constant churn of users. The idea is to foster interaction, with a package of shared services compensating for a reduction in individual workspace. Today, this cosy-sounding model has lost some of its former appeal. For the moment, activity has more or less stalled; while the lockdown has certainly bolstered remote working, employees, entrepreneurs and freelancers alike are mostly stuck at home. Just 4% of those who used a co-working space in the pre-Covid era have continued to do so amid the current restrictions (source: Morning Coworking).

But what about the future? In the very short term, there is likely to be less enthusiasm for this kind of workspace solution. Fears of a second wave of infections, combined with misgivings over the crowded environment and intermixing of teams, could linger for some time.

Eventually though, the fear of the other will abate, and the coworking model may well survive and thrive in the longer term. Uncertainties over public health and the state of the economy will continue to weigh heavily on our minds, and that could ultimately play to its strengths. This model's basic USPs — flexibility and adaptability — will look like deal-making advantages at a time when the future is hazy and the present highly volatile, particularly for major corporations, a potential growth market for coworking operators. More flexible solutions may begin to seem like a wiser choice given the cloud of unknowns hanging over their real estate projects.

If so, in a few months' time operators may be basking in a new-found popularity — despite their current distress in a scenario where traditional office property is more easily found and more affordably priced. This does, however, assume that they are able to withstand the immediate crisis and sustain the quantity and quality of their product.

“Just like traditional offices, co-working spaces are not doomed to be consigned to history. The boundary between the two models will gradually fade, creating more and more scope for an intermediate solution, dubbed the ‘managed office’. Although still at an embryonic stage, this model can already be found in the French market (just ask our occupier services team) and we believe it has a bright future ahead of it, since it responds so perfectly to the kind of flexibility today's companies require.”

Serge Vayer, Director Tenant Representation

At the moment this still seems the most plausible outcome, but with so much up in the air, it remains an educated guess. As INSEE observed in its latest note on the economic climate, this is not a time for “simple” predictions. That's putting it mildly.

What we do know is that the Q1 figures are not encouraging, boding ill for the year ahead in the lettings market. In the short term, then, we know what to expect — and it's not good news. As we move into the future, hopes of a reprieve are not unfounded, but nobody can predict when the turning point will come, or how tough things might get in the interim.

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