France – December 2019

SPOTLIGHT

Savills Research

Investment France Q3 2019

Towards a new record ● Paris, 1st European market ● Resumption of the compression in yields

Economic climate
Stable with a clear view ahead

Compared with its main neighbours and trading partners, France's economy is proving remarkably resilient. Although growth forecasts have been downgraded more or less everywhere as the overall outlook darkens, France seems to have been spared the worst. There may be nothing spectacular about the country's recent economic performance, but it does offer a certain stability in a volatile and increasingly unpredictable climate – a solid advantage in the eyes of

Slow, steady and sustained, the French economy is currently making a virtue of consistency, with overall growth coming in at 0.3% for the third consecutive quarter. No cause for complacency, certainly, but with global economic forecasts growing gloomier by the day, France is looking like a relatively safe bet. In fact, figures for Q3 were slightly stronger than generally expected [1]. The growth rate carried over at the end of the quarter stood at 1.2%, up from 1.1% in June. The latest forecasts for the end of the calendar year suggest an annual growth figure of between 1.3% and 1.4%, with little change on the cards for 2020.

Compared with the recent performance of many other European economies, this almost makes France a winning prospect. In the United Kingdom, despite similar levels of market activity, economic growth has been tailing off for some time, and figures for Q3 fell short of expectations. Germany has narrowly avoided official recession territory this quarter, but its economy is not anticipated to grow by more than 0.5% in 2019, rising to between 1% and 1.2% in 2020. Finally, the Italian economy remains stuck in the doldrums and is likely to end the year on an annual growth figure of just 0.1%, although again the forecast for 2020 (0.6%) is slightly brighter.

The way the French economy is structured, with a lower degree of exposure to the oscillations of international markets than many other countries, explains its ability to sustain this almost salutary performance. Exports of goods and services account for just 31% of France's GDP; in Germany, it's nearly 50%. This means that the progressive deterioration of the international climate amid tensions between the USA and China has less of an impact on France.

Its economy remains primarily driven by domestic demand, whether in the form of household spending or corporate investment. Many companies are taking advantage of low interest rates to upgrade their capital assets, pushing corporate investment up by 1.2% at the close of Q3. Meanwhile, household spending was up 0.3% at the end of the quarter. There are two main factors behind this boost in consumer confidence. First, the labour market is performing strongly; unemployment has been falling slowly, and this is expected to continue over Q4, reaching 8.3% of the active population by the end of the year. Second, households have enjoyed a bump in purchasing power, also likely to continue through Q4 as the latest round of cuts to the residence tax come into effect. Overall, by the end of 2019 French households should have seen their purchasing power grow by 2.3%, compared with just 1.8% in 2018.

The relative stability and resilience of the French economy appears to be giving it an edge in a particularly volatile global climate. Effectively, these qualities give investors and other financial decision-makers a clearer idea of what the future might hold in the medium term. Indeed, the perception of France as a relatively safe harbour is driving a good deal of the interest we are seeing from international investors.

[1] Reuters had set its consensus forecast at +0.2%.

1.3% - 1.4%

Estimate of GDP growth in France for 2019

+1.2%

Rebound in business investment in Q3 2019

8.3%

Unemployment rate expected in France at the end of 2019, its lowest level since early 2009

+4.5%

Strong increase in the total number of business start-ups in September 2019 (+ 15.7% in the last 12 months)

The investment market in France

Powering ahead

All of the signs are there: 2019 is set to be a record–breaking year for the French investment market. We are now predicting that total investment will come in close to €35,000 million, and there's more – Paris has overtaken London as Europe's top investment destination. It's an impressive showing for France in a year when the international climate has grown decidedly bleaker.

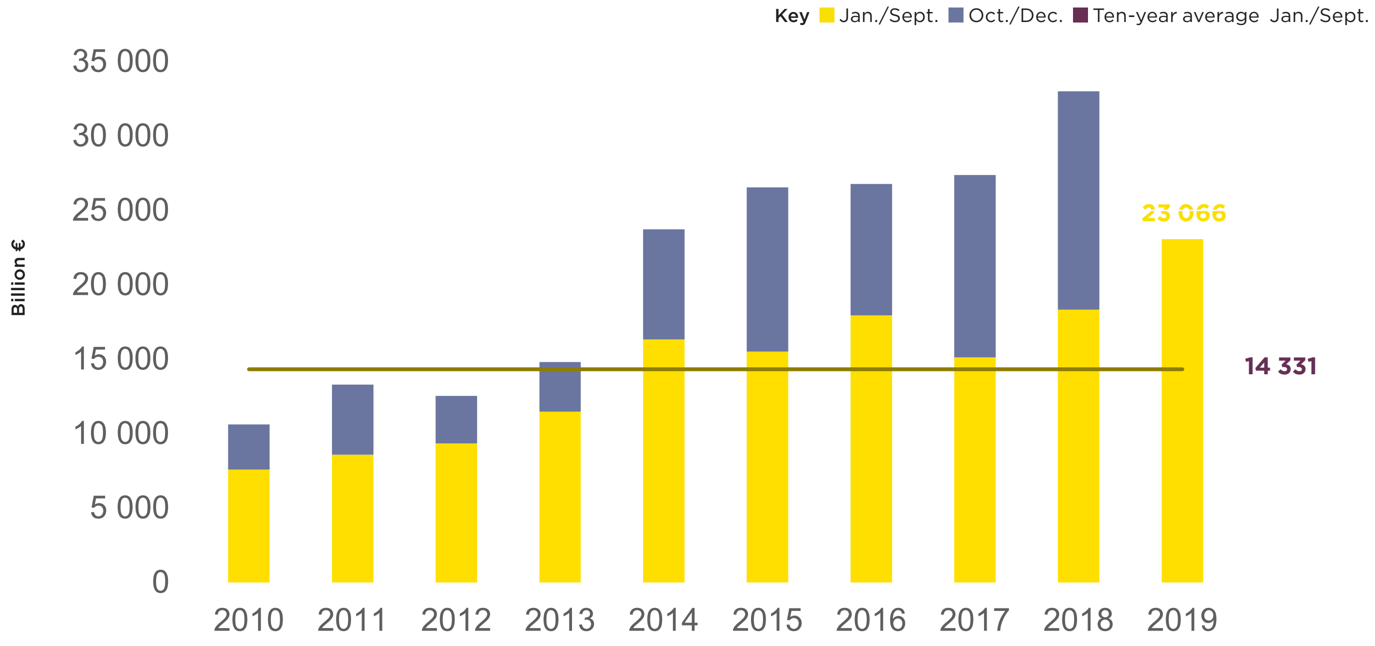
Investment volume: A race to the top
Things have been hotting up in the French investment market since 2019 began. If the first half of the year was strong, the second is shaping up to be exceptional. By the close of Q3, France had attracted investment of more than €23,000 million, a 26% gain on the same period of 2018. Even more remarkably, the market is currently outperforming its ten-year average to the tune of 61%. Last year's record level of investment seems fated to be eclipsed by 2019's stellar performance.

The buoyancy of the French market is especially striking given the fairly dismal state of affairs in the global economy as a whole. Across Europe, investment is down almost 6%, with a total volume of just under €190,000 million over the first three quarters of the year. Out of the three largest European markets, France is the only one to report positive investment growth. As a result, the French market's third-place position is looking more and more secure as it edges closer to its biggest rivals: Germany, on a total investment volume of €55,000 million (down 1%), and the UK, on €39,000 million (down 28%).

Paris, without question, takes the crown: the French capital is now Europe's premier investment destination, a pivotal feat that perfectly encapsulates the ebullience of the national market. Since the start of 2019, investors have poured €16,900 million into the city (up 27%), which is on track to close the year well ahead of London (€14,200 million, down 36%). Strange times, indeed. Munich is predicted to take third place, but despite a 15% boost, on €4,600 million it's trailing far behind the top two.

Source of funds invested: France: a safe harbour for international investors
The summer of 2019 may have consolidated its position, but the French market has been gathering momentum for some time, impelled by a combination of key factors. Chief amongst them is the current international climate, a hot topic in recent months. Despite the economic downturn affecting every part of the globe, major international investors (particularly institutional investors) are still sitting on substantial sums, just waiting for the right opportunity. Those are not always easy to find, and based on an analysis of the risk-return trade-off there is often a good case for caution. The current level of political and economic instability is a weighty consideration, as is the volatile money market. Amid these concerns, real estate – and particularly French real estate – starts to look like a tempting opportunity.

France: Investment volume over times



Source Savills Research

The appeal of the French property market is largely attributable to its financial resilience, the quality and strength of its lettings market and its high levels of institutional stability. This latter point counts for a great deal, as it allows a clear view ahead to the medium term – a rarity in the current climate. France has also benefited from the fall of the euro against most other world currencies, giving French real estate a competitive advantage with the promise of a potential upside.

The end result is that international investors now account for 50% of France's total investment volume, compared with 41% a year ago. This level of international investment has not been seen since the financial crisis of 2007/2008. The first nine months of 2019 saw investors from the Asia-Pacific region make further inroads into the French market, particularly those from South Korea, who together invested more than €4,000 million – 21% of the national total and 29% of the total investment volume in Île-de-France. At the same point last year, these investors represented just 2% of the French market. This sudden surge has been on the horizon for two or three years; it seems that investors who have been sizing up the market for some time are now making their moves, with some major deals concluded since the start of the year. While this first wave of new entrants, primarily composed of South Korean institutional investors, will inevitably subside, there may well be others not far behind – namely new Korean funds and other investors from Asia and the Middle East.

The dazzling favour of South Korean investors has been so great that it has somewhat overshadowed the renewed interest from German funds and European pension funds, mediated by asset managers. These actors are increasingly drawn to properties valued at up to €100 million, traditionally the preserve of SCPIs. Although fairly unobtrusive, this uptick in interest has all the appearance of a long-term shift.

The international context has been crucial in this respect, but there are a few other factors at work. Summer 2019 brought another development that must take some of the credit for the record levels of investment that France has enjoyed this year: a rebound in domestic demand. Outstripped by international investors in the first half of the year, French buyers returned to the market with renewed zeal over the summer months. They now represent just over half (51%) of all investment in the French market since 2019 began. It's a big step down from the 59% recorded this time last year, but a respectable advance on Q2, when French investors made up just 47% of the market. More aggressive investment strategies, coupled with the completion of some high-value deals outside the mainstream Paris office market, are the main factors driving this resurgence. Notable transactions involving French buyers include the acquisition of 33,000 sqm in the Académie building in Montrouge, 66,000 sqm in the To Lyon building in Lyon and equity shares in the Italie 2 and Passage du Havre shopping centres in Paris. Given that many French investors are currently cash rich and opportunity poor, this trend is unlikely to die down any time soon. At the close of Q3 2019, SCPIs were reporting an unprecedented level of investment, up as much as 75% year on year. Plenty to keep the engine churning, then...

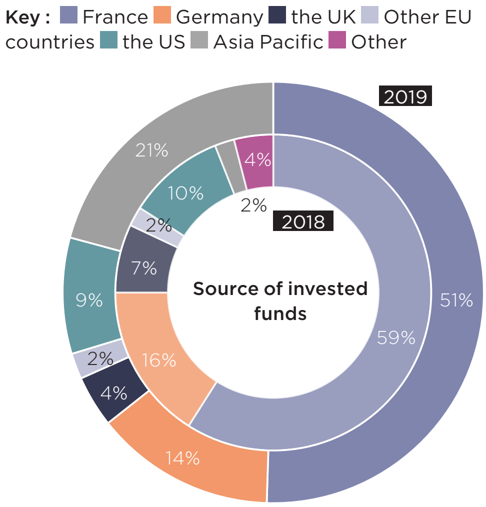
Type and quality of transacted assets: Security rules OK

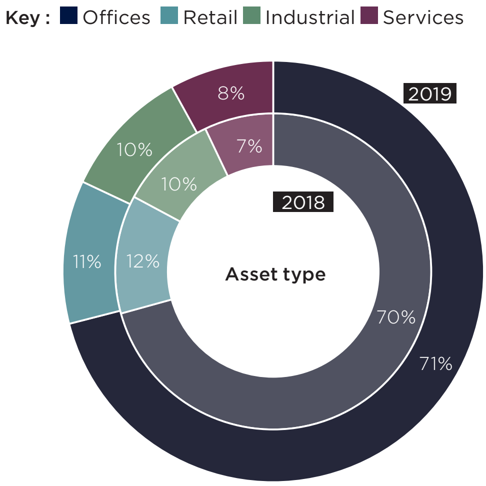
Demand is strong – there is no question about that. But how is the supply side bearing up? Here, the limitations of the French market become more apparent, although the same could be said for most other European economies. The rise in the number of international investors since the beginning of 2019 has pushed up demand for Core properties; these are now soaking up 82% of the total investment volume, compared to 72% at the same point last year. Unsurprisingly, new entrants prefer their acquisitions to be secured when taking their first steps in an unfamiliar market.

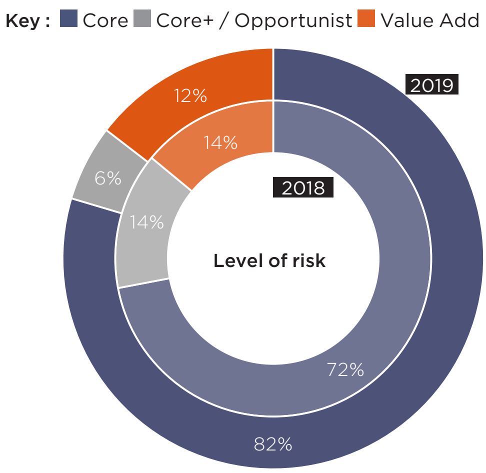
However, this renewed convergence around Core property is also an artefact of the influence of a handful of high-profile transactions on the rest of the market. Opportunities commanding unit amounts in excess of €500 million account for 24% of investment in 2019 so far, compared with just 9% in the first three quarters of 2018. Half of the investment volume for the first nine months of 2019 can be traced back to just 27 transactions; in the 2018 figures, you would need to take the top 38 transactions to reach the same proportion by the end of Q3, and the sums involved were much more modest.

If there's one catch in the extraordinary success of the French market in 2019, it's here: with investment concentrated on just a few major transactions, there has been a spike in volume,

France : Distribution of invested volumes
Compared period: January - September







Source Savills Research

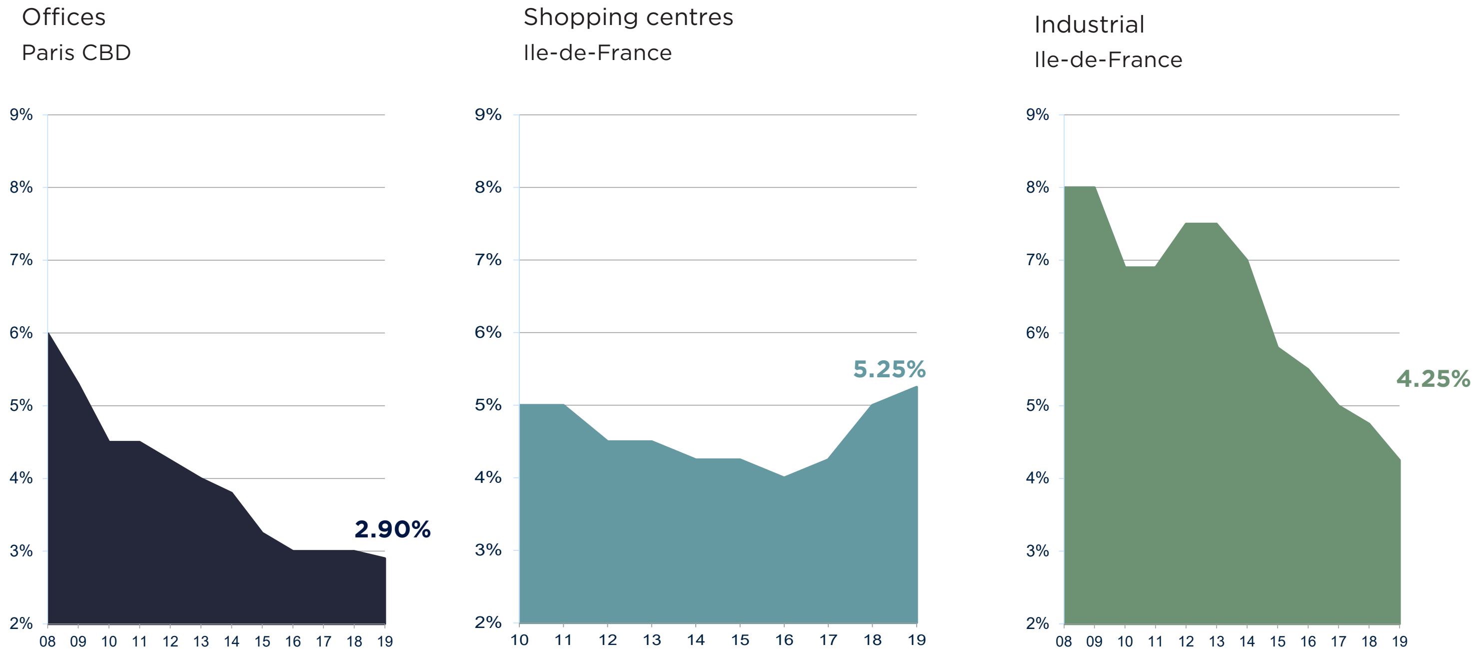
but 20% fewer transactions, with the sharpest drops in the sub-€100 million segment.
This level of market concentration explains another striking feature – the clear and sustained dominance of the office sector, representing over 70% of the total investment volume. Nevertheless, there has been a distinct shift since summer 2019 and we are now seeing gains across all other property types, from service provision (up 42%) to retail (up 13%). This revival in alternative investment options has coincided with the upturn in domestic demand.

Yields: The yield curve heads south
In this highly upbeat market, where demand for Core property remains strong, prime yields have resumed their downward course. This marks a new juncture following three years of stability, at least in the office sector.

In the Paris CBD, for example, yields for the most desirable office buildings have now dropped below the historical benchmark of 3.0% to stabilise at 2.90%. This is entirely unremarkable given that, in addition to the prospect of reversion raised by rental growth, real estate assets still hold a relative yield advantage. At the end of September 2018, the spread of bond yields came in at 226 basis points. One year later, it's back up to 316 basis points, exceeding the ten-year average (215 bps) by quite some margin.

Outside of the prime segment, distinctions are becoming increasingly fine, with Core+ and Value Add properties coming to the fore. In central Paris, the vacancy rate is so low, and the shortfall of Grade A property so acute, that the risk incurred by entering the lettings market is no longer a deterrent. Meanwhile, properties due for a rent adjustment (whether sublet, in need of a revamp or occupied by tenants on a short lease) might just look like golden opportunities for a secure investment with scope for creating value. These properties are now attracting attention from investors who would traditionally have confined themselves to the Core segment. Inevitably, this has produced a tighter yield spread for prime properties. While the quality of properties on offer is a key consideration, this yield compression can be seen in almost every location. Opportunities arising on the outskirts of the main established business districts, in emerging markets in Paris (the potential of the Grand Paris scheme is also a factor here) and even in regional capitals are now firmly on the radars of a growing number of prospective buyers. This is particularly true of European investors, who have proven very keen to participate in bidding for properties valued at up to €100 million, compounding the downward pressure on yields.

France: Prime yields by type of asset



Source Savills Research

The geography of investment
All eyes on Paris
The Paris region has a prominent place in this flourishing French investment market.

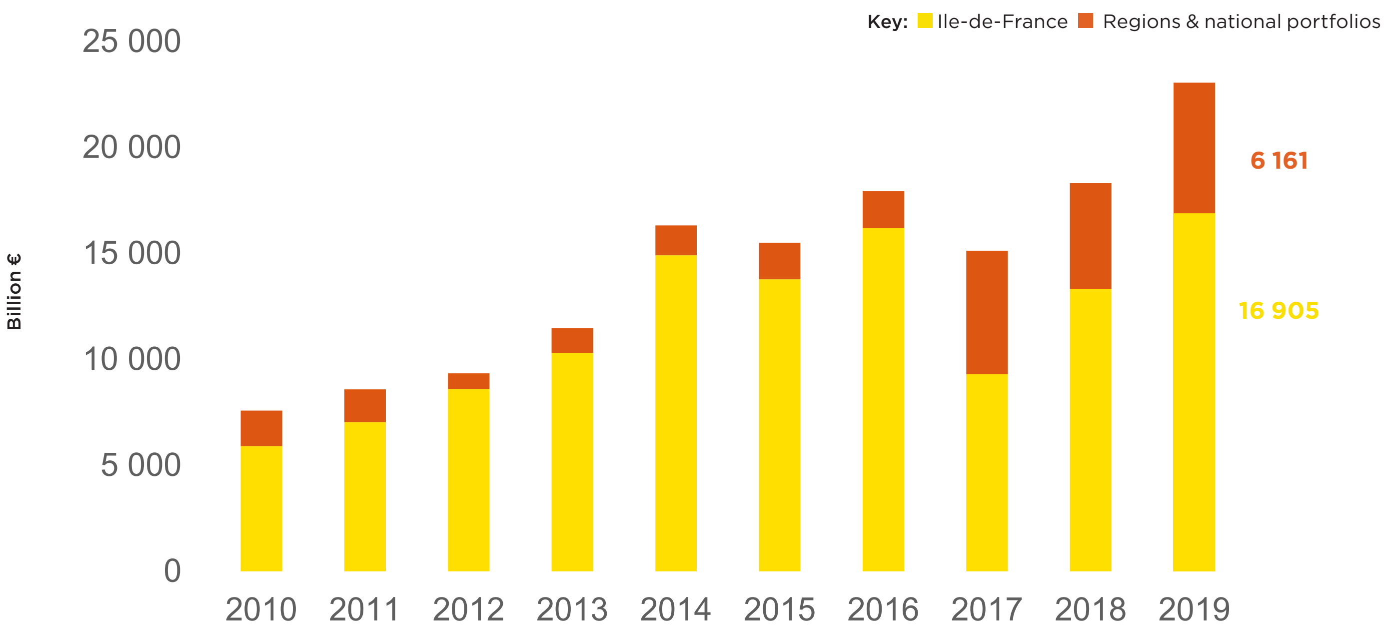
Every market has its own traditions. In France, everything revolves around the capital, and the current performance of the investment market presents no serious challenge to this model. The greater Paris region has always wielded a disproportionate influence, and it still does. In fact, the Paris real estate market has attracted almost €17,000 million in investment over the first nine months of 2019: 73% of the country's total investment volume. The opportunities emerging in France's various regional capitals, together with the divestment of national portfolios, have done nothing to dislodge this pattern; the stream of funds pouring into Île-de-France is still growing faster than the national average (up 27%, versus 23%). Even more welcome is the news that Paris has now overtaken London as the most prized destination for investment in Europe.

Île-de-France is the primary point of entry for international investors dipping their toes in the French market. The influx is growing, and the majority of these funds will never leave the greater Paris area. Moreover, while domestic investors still outnumber international investors in France overall, this is no longer the case in Île-de-France. Here, 55% of all investment in 2019 so far is attributable to international investors.
These actors have spotted an opportunity that seems to meet all of their needs: high-value, secured assets, good market depth and perfect fluidity. The current structure of the Île–de–France market is a reflection of this dynamic. This is a market dominated by very substantial deals, the key drivers of activity since 2019 began. These transactions, involving unit amounts in excess of €500 million, currently account for 26% of investment volume in the greater Paris area. That's a big jump from the 12% recorded in 2018. With its perfect fluidity, office property is by far the most sought after, representing 83% of the total investment volume in Île-de-France compared with just 39% in other regions. Finally, the dominance of Core properties has become even more entrenched since 2018.

This particular market configuration puts the CBD at a disadvantage. Although still the destination of choice for investors seeking Core property, the CBD has relatively little in the way of the very large properties that major investors are looking for. Furthermore, after the high levels of activity we've seen in the last few years, opportunities in this market are starting to dry up. As a result, investment in the CBD is actually down 47%, coming in at a little over €1,500 million at the close of Q3. That's quite a drop, but it is important to view it in the proper perspective. The outstanding results of 2018 set a very high bar, and this year's figures have been heavily skewed by portfolio activity. The Terreis portfolio is a perfect example. This mammoth transfer of €1,800 million is not easy to pin down geographically, but a good part of this sum can be attributed to the value of properties in the Paris CBD.

In contrast, the rest of central Paris (up 23% on €3,300 million), the Inner Suburbs (up 49% on €2,000 million) and, especially, La Défense (up 280% on €2,500 million) are all set to end the year on a triumphant note. Île-de-France may cast a long shadow, but there's more to the French market than Paris and its hinterland. Investment activity in other regions has been on the rise for the last three years, and now represents 27% of the national total (based on the 2017-2019 average). If we look back at the figures for 2010-2016, we find that only 10% of France's total investment ventured beyond Île-de-France. This turnaround has been made possible by the transfer of certain major assets, such as the To-Lyon tower in Lyon, but increased market activity around national portfolios (some of which also include properties in Île-de-France that are tricky to localise) has also played a pivotal role. Compared to the greater Paris area, where the office sector rules supreme, these markets are much more open to alternative property types. As a result, they tend to benefit in periods when investors are looking to diversify.

France : Jan-Sept 2019: Investment volume by location

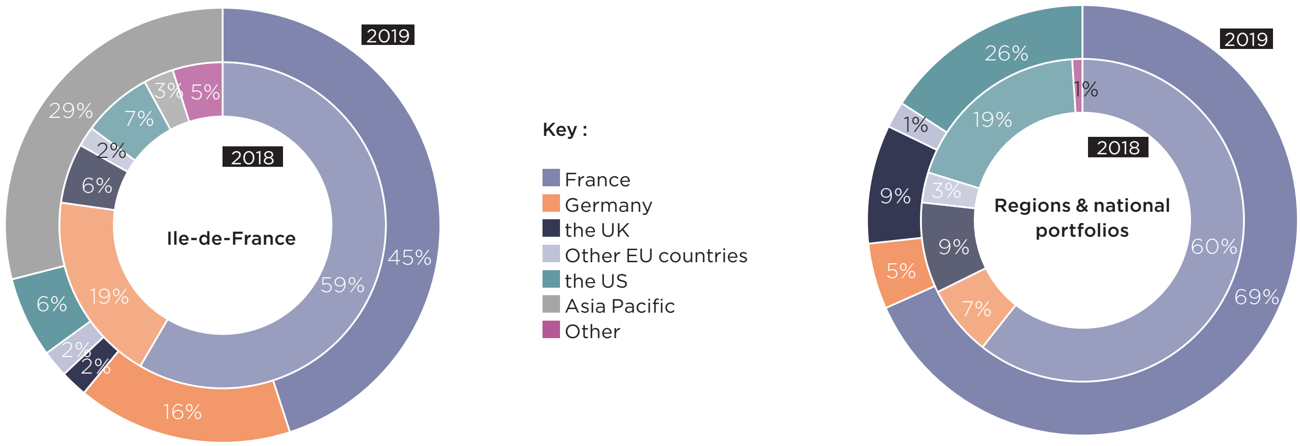


Source Savills Research

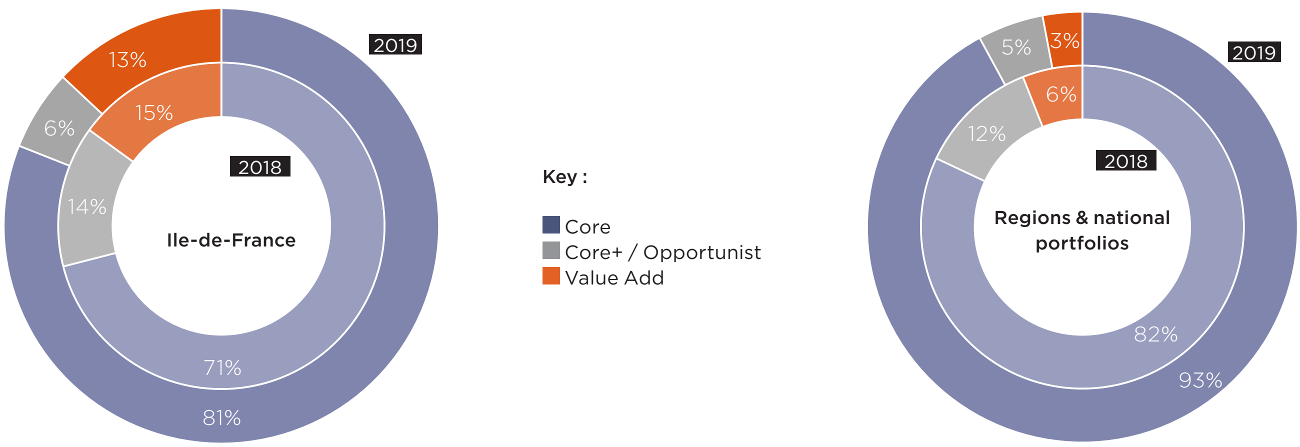
In a nutshell: What makes the Île-de-France market different?

Ile-de-France vs the Regions: Invested volumes by asset type
Compared period: January - September

Ile-de-France vs the Regions: Source of invested funds
Compared period: January - September



Ile-de-France vs the Regions: Invested volumes by risk level
Compared period: January - September



Source Savills Research

Outlook

Beyond all expectations

By the end of 2019, the French market will have chalked up some phenomenal figures. There is every reason to believe that this year's performance will smash the record set in 2018, and that the prediction we made back at the end of Q2 – an investment volume of over €33,000 million by the end of the year – will soon seem overly timid.

The current economic climate is particularly auspicious for the French investment market, but can it persist beyond 2019? From what we can tell, the stars will remain favourably aligned for at least another few months.
The current policy of the European Central Bank, the so-called 'monetary bazooka', combined with a fresh round of bank refinancing (intended to encourage banks to keep credit lines open), should help keep a lid on interest rates and ensure ready access to financing.

This change in the ECB's monetary policy is a response to a deteriorating economic outlook and an uncertain international climate, which is having a dampening effect on international trade. This situation is of equal concern to investors, some of whom are sitting on substantial sums of ready cash and are therefore anxious to seek out the best opportunities they can. Security is the top priority for these investors at the moment, and this is unlikely to change in the near future. Historically, this kind of caution has always worked in favour of the bond and real estate markets.

As the international landscape has changed, France has become a winning prospect once again, and the country's economic and institutional stability has much to do with its success. The French real estate market should therefore remain a destination of choice for international investors with Europe in their sights. This applies especially to German investors, who traditionally have tended to overlook the French market but are now intent on increasing their presence here, as we have been seeing since the start of 2019. Value Add and opportunistic funds, often hailing from English-speaking countries, are being lured in by weak supply, a robust lettings market and the potential for reversion. These funds will continue to seek out new opportunities in France. However, interest in the French market has now spread well beyond the usual suspects, as shown by the determined advance of South Korean funds. There is every reason to believe that we will see more and more new entrants looking to gain a foothold here, in addition to the South Korean institutional funds that have already taken the plunge.

Combined with the scramble for capital among French SCPIs and OPCIs, these factors suggest that the market will continue to attract record levels of investment in 2020, very probably in excess of €30,000 million.

This momentum will undoubtedly have an impact on yields and their underlying structure. The gap between bond yields and those achievable in the real estate market is doing a great deal to boost activity; we believe that the renewed tightening of prime yields we saw in Q3 2019 could well continue for another few months. It may even spread to other markets beyond the CBD and other well-established locations, in which case we can expect a further squeeze on yields across the board.

The extent of this tightening will depend largely on how bond yields perform, and on conditions in the banking and monetary environment. For now, it seems reasonable to expect that yields will fall, but not to a spectacular degree.

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