France - March 2019

SPOTLIGHT

Savills Research

Investment France 2018

savills

Investment volumes : new record in 2018 ● Strong prospects for 2019 ● Emergence of new opportunities

+1,6% **France 2018**
GDP growth

+1,5% **France 2019**
GDP growth forecast

Economic climate

Between dusk and dawn

At the global level, growth remains sluggish. Amid international trade tensions, uncertainty over how Brexit will play out and various other destabilising factors (social and political unrest in several European countries, volatility in the financial markets, emerging economies in flux, etc.), the economic climate is looking distinctly stormier than it did at the outset of 2018.

In Asia, China's performance is failing to live up to expectations (+6.6%, the lowest level of growth in 28 years); in Europe, Italy slipped into recession in the second half of 2018 and the German economy is rapidly losing steam. GDP growth for the Eurozone as a whole came in at 1.8% in 2018, trailing far behind the 2017 figure of 2.7%. Q4 2018 was particularly lacklustre, and there are no signs that early 2019 will be much better.

Indeed, the IMF recently downgraded its growth forecasts [1] to reflect more modest expectations for global GDP growth: 3.5% for 2019 (0.2 of a percentage point lower than previously projected [2]) and 3.6% for 2020 (a markdown of 0.1 of a percentage point). Almost every economy on the planet has been affected by faltering growth. Although the US economy is still expected to grow by 2.5% in 2019, the effects of the budgetary stimulus package are waning and in 2020 the pace of growth is set to drop to 1.8%. In China, while the economy is still growing at a rate most established economies can only dream of, the tempo is steadily slowing (the forecast predicts 6.2% growth in both 2019 and 2020). ▼

While clouds continue to gather, France appears to have escaped the worst. Here, the IMF expects to see a rate of growth similar to that of 2018, estimated at 1.5% in 2019 (a downward revision of just 0.1 of a percentage point) and 1.6% in 2020.

The impact of the "yellow vest" (gilet jaunes) movement, while clearly unhelpful, has been less damaging than once feared. In Q4 2018, the French economy grew by 0.3%, level with the previous quarter.
Unemployment continues to fall; at the close of 2018, France's unemployment rate stood at 8.8%. Although well above the European average, this is the lowest level of unemployment the country has seen since 2009.
Household morale, after plummeting from November 2018 on, bounced back by five points in January, at 91 points [3].
Meanwhile, and almost in step, movement in the PMI index signalled an upturn in the business environment, bucking the forecast for the start of 2019 [4].
Finally, international investors are still keeping a close eye on the opportunities presented by the French market. That is the view expressed by the French-American Chamber of Commerce, for example, in reporting its annual survey of American companies: 'For American investors, France is more attractive now than ever before.' [5]

A relatively safe harbour in a global landscape that has grown gloomier and more turbulent over the last few months, France should ▼ ▶ continue to reap the rewards of a flexible monetary policy and favourable financing conditions. Recent fears of a significant tightening of monetary policy in the USA or the Eurozone in 2019 have now abated. Jerome Powell, Chair of the Federal Reserve, has pledged 'patience', and his counterpart at the ECB is of the same mind. It seems likely, then, that Mario Draghi will reach the end of his term without having overseen a single rate rise. The maintenance of this so-called 'monetary bazooka' should have a stimulating effect on economic activity in 2019.

These unexpectedly favourable monetary conditions may be augmented by various new steps aimed at boosting household consumption. In France, measures announced on 10 December in response to the yellow vest movement are expected to give rise to a significant jump in purchasing power. The Public Policy Institute (IPP) puts this at 0.8% on average [6], while the French Economic Observatory (OFCE) estimates that each household will see a gain of €440, which could potentially boost economic growth by 0.3% [7]. This recent spotlight on purchasing power is not a purely French phenomenon. Spain, despite parliamentary rejection of its 2019 budget, has approved a dramatic hike in the minimum wage, and Germany's social partners have reached agreement on numerous salary adjustments that are being rolled out over 2018 and 2019. Demand for similar action is mounting in Belgium and Italy. On the other side of the Atlantic, too, salaries have been rising at a faster rate overall since summer 2018.

Were it not for fears of a transpacific trade war and trepidation surrounding Brexit, there would still be some hope of offsetting the slowdown that struck in 2018. On presenting these latest forecasts, the IMF made its position clear: the priority for the international community should be to resolve its differences quickly and in a spirit of cooperation, rather than risk further escalation of uncertainty and damaging barriers to trade. The next few months will tell whether Christine Lagarde and her team are just whistling in the wind.

> **"In an increasingly challenging international economic context, France appears to have been relatively spared. In 2019, it is expected to grow significantly faster than Germany."**

▶ That said, the darkening outlook for growth is first and foremost a product of events in Europe. The Eurozone is projected to grow by just 1.6% in 2019 (down 0.3 of a percentage point) and 1.7% in 2020. The slowdown in Germany (-0.6 of a percentage point, with forecast growth of 1.3% in 2019 and 1.6% in 2020) and Italy (-0.4 of a percentage point, with growth of 0.6% in 2019 and 0.9% in 2020) were the main factors behind the IMF's decision to tone down its outlook for the Eurozone.

[1] IMF, 21 January 2019
[2] October 2018
[3] INSEE, 29 January 2019
[4] Markit Composite PMI Index, 5 February 2019
[5] Marc-André Kamel, partner at Bain & Co. and vice-president at AmCham, Les Echos, 6 February 2019
[6] Public Policy Institute, January 2019
[7] OFCE, 30 January 2019

14%
France's share of volumes invested in Europe

€32.5 billion
invested in France in 2018

+21%
Increase of volumes invested in France in 2018

The French market in 2018

The strength of Hercules

Average annual volume invested in France & record years

1990 / 1994
€2.6 billion

1995 / 1999
€3.9 billion

2000 / 2004
€11.3 billion

2005 / 2009
€19.3 billion

2007 : €29.9 billion

2010 / 2014
€19.2 billion

2015 / 2018
€29.5 billion

2016 : €29.7 billion

2018 : €32.5 billion

Source Savills Research

The French market had never seen such high investment levels. Corporate real estate generated an investment volume of almost €32.5 billion in France during 2018. The previous record dates back to 2007, when the market hovered around the €30 billion mark.

The volumes are impressive, but the growth is just as remarkable: the amounts invested in real estate assets have risen by 21%. France's performance is all the more remarkable given that it took place in a much less buoyant European context, down 6% in 2018. France accounted for 14% of European investment volumes (excluding Russia), compared with 11% in 2017.

The French market is admittedly still far behind the two European giants, the United Kingdom and Germany (with 64.4 and 60.4 billion euros respectively in 2018), but it is performing much better: while the market in the United Kingdom shrank by 9% in 2018, the market on the other side of the Rhine recorded only a modest 2% increase. France has thus consolidated its position on the podium of the three leading European markets. It also has real growth potential to move closer to the volumes of its main competitors. ▼

> **“Investment volumes in France reached an all-time high in 2018. But this is not just a record. What is really impressive is the change in the size of the French market: it is now one of the big players on the international scene.”**
> Boris Cappelle, CEO Savills France

▶ The progress and performance are considerable. However, 2018 is not just a record year that can be relegated to the rank of an epiphenomenon, but is rather part of a long-term trend that reflects the growing importance of the French market. 2018 was the fifth year in a row to end with a volume of activity exceeding 25 billion euros. Prior to this period, such an amount had only been reached once before (in 2007). We are indeed witnessing a change of scale...

This change and the go-it-alone approach of the French market in Europe may be surprising. However, they follow a logic: French real estate regained its appeal throughout 2018 as a result of the decrease in yields seen among some of its neighbours, while French yields, which had previously decreased significantly, stabilised.

France has also been able to count on other key strengths: due to the depth and resilience of its rental market, the prospects offered by its economy and the confidence inspired by the reforms advocated by the government among international investors, attention has been focused on certain categories of alternative or value-add real estate assets, offering the possibility of higher yields than for Core assets.

> **The predominance of office assets increased in 2018, with a 25% increase in investment volumes. But it is the emergence of service-related real estate, which grew by 73%, that is undoubtedly the year's most ground-breaking phenomenon.**
> Thomas Canvel, Managing director Investment department

Risk level & type of assets

Grow and multiply (the alternatives)

This growing interest in the diversification opportunities offered by real estate investment will indeed be one of the defining features of 2018.

While the major structural balances of the French market have not been called into question, they have nevertheless undergone significant changes. The dominance of the office sector is a perfect example. This eminently Parisian asset class has always benefited from the prominence of the Paris region in the French market. And indeed the dominance of office buildings has persisted, and has continued to attract an overwhelming majority of French investment volumes (72% in 2018, a level roughly equivalent to that observed over the past decade).

But this has only been made possible by a much larger number of acquisitions of properties under development, in need of refurbishment or with Value Add potential. The share of Core assets fell by 10 points in one year, from 88% of investment volumes in the office sector in 2017 to 78% in 2018. At the same time, the share of Core+ assets increased from 6% to 11% and that of Value Add assets from 7% to 13%. In addition to the fierce competition between buyers for prime buildings, which leaves many of them dissatisfied in terms of their needs, this phenomenon is rooted in the contextualisation of the notion of risk.

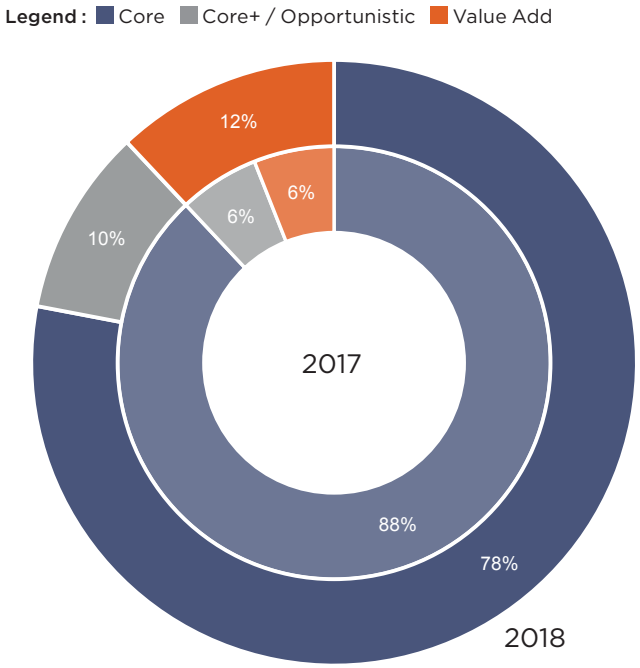
Where is the risk in buying a well-positioned building to be constructed or redeveloped in the Greater Paris Region market where annual take-up averages 2.33 million sq m (ten-year average), where the vacancy rate fell below 5.5% at the end of 2018 (2.3% in Inner Paris), where Grade A supply is plummeting in the most popular districts and where over two-thirds of the office stock is more than 20 years old? The answer is that there is little or no risk. As a result, Core+ and Value Add acquisitions, which were previously the preserve of players with an opportunistic strategy, are increasingly opening up to investors who have traditionally sought security.

Another diversification approach that is increasingly being explored by investors is that of alternative assets to the office sector. While investment volumes in retail assets are slowing down (-3% in 2018) due to questions about the adaptability of the business model of certain brands and facilities (particularly shopping centres), industrial and logistics assets are still in demand. They attracted almost €2.9 billion in 2018, an unprecedented volume.

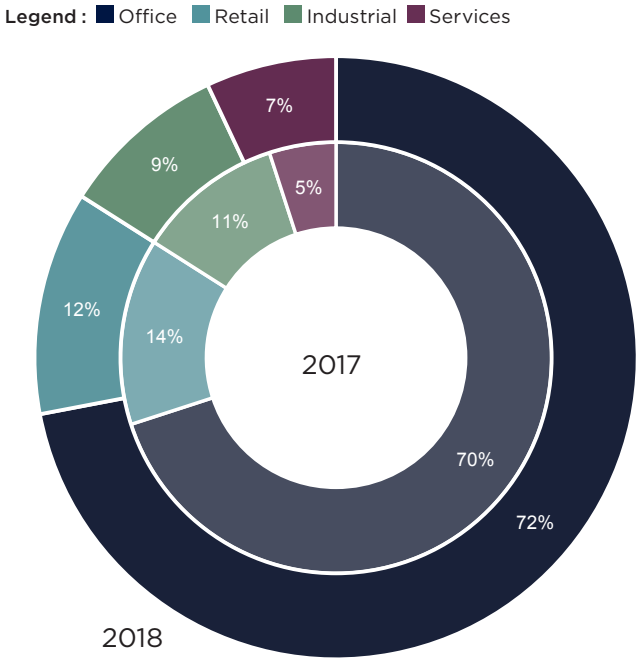
But the most striking phenomenon is undoubtedly the rise of service-related real estate (hotels and, increasingly, senior and student residences as well as co-living assets). This sub-sector attracted almost €2.4 billion in 2018, an annual increase of 73%.

2017 & 2018 : Investment volumes in France

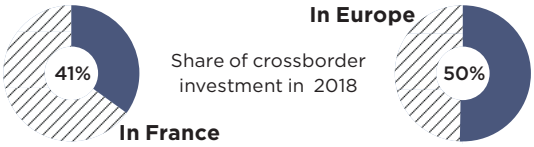
By risk level



By type of assets



Source Savills Research



+103% Increase of crossborder investment in France in 2018

Origin of funds invested

A foreign wind swells the sails of the French investment market

The notion of contextualised risk and asset diversification are therefore two explanations for the dynamism of the French market. But they are not the only ones. The strong level of activity observed in 2018 is also due to the increasing internationalisation of the market.

The trend, which began in 2017, continued in 2018: the proportion of international funds increased from 25% of investment volumes in France to more than 41% in one year. This increase is due largely to the interest of American investors (who increased from 3% to 11% of investment volumes between 2017 and 2018), particularly attracted by the opportunities offered by Core+ and Value Add assets. They are closely followed by the Germans (4 to 10%) and the British (5 to 8%).

On the other hand, the share of Asian investors declined in 2018 following very high levels of activity in 2017. But this decline is only temporary and 2019 should confirm the growing interest of these players in French real estate.

This internationalisation has its origin in the inherent qualities of the French market, but is also primarily due to how other countries assess it. Everything is often a matter of comparison: in addition to its renewed appeal as a result of the good spread in yields, France has clearly benefited from the uncertainties and doubts that are troubling the future of some of its neighbours.

The growing exposure of the French market to international cash flows is undoubtedly not yet over. Despite the impressive progress observed in 2018, its degree of openness is anything but exceptional and, at a European level, international funds represented on average 50% of the amounts invested in 2018. There is therefore still scope for development for them.

This would re-establish a long tradition of openness that prevailed until the outbreak of the 2007/2008 crisis. This tradition has been somewhat forgotten due to the formidable development of domestic investors over the past decade, as a result of the surge in funds collected by SCPIs and OPCIs, as well as the growing interest of institutional investors in corporate real estate investments. There was little room left for others.

The weight of these domestic investors remains critical, with 59% of the volumes invested in 2018. Nevertheless, it fell both in share and volume, from €20 billion to €19 billion in acquisitions in one year. This decrease is due to lower fund inflows, sometimes deliberately limited for fear of not being able to invest all the funds due to a lack of investment opportunities, as well as increasing exposure to foreign markets, particularly in Europe. Investment is thus increasingly comprised of incoming and outgoing cash flows.

Y-o-y change (2017 / 2018) in investment volumes in France

By type of assets

+25%
Office

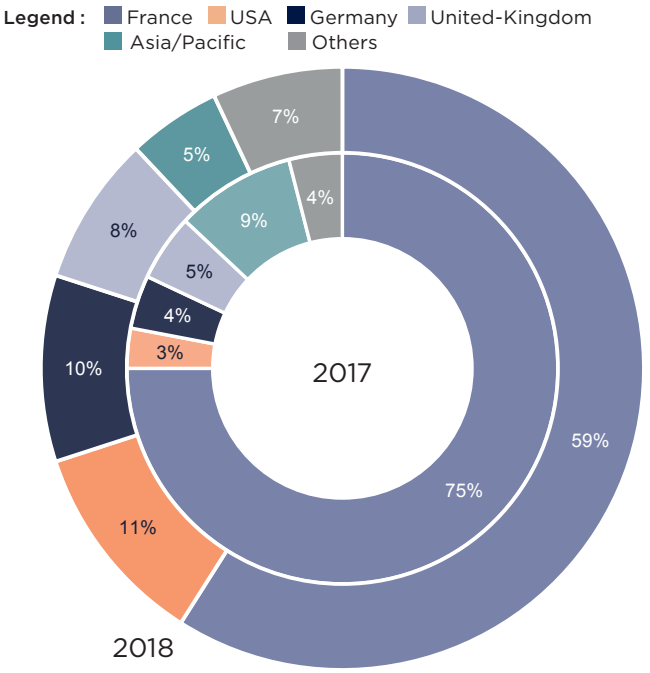
-3%
Retail

+1%
Industrial

+73%
Services

Source Savills Research

2017 & 2018 : Origin of funds invested in France



Source Savills Research

> **While prime rates in the most established markets did not change in 2018, the risk-based yield curve is tending to flatten out.**

Yields

Relative yield theory

In such an active market that sometimes struggles to satisfy demand, particularly for Core assets, prime yields remain at historically low levels. The compression phase is of course over, and this is one of the explanations for the strong international appeal of the French market. But there is still no sign of an increase in prime yields: stability prevails. In the Paris CBD, for example, yields for high-quality office buildings remain at 3.0% and have not moved since the end of 2016.

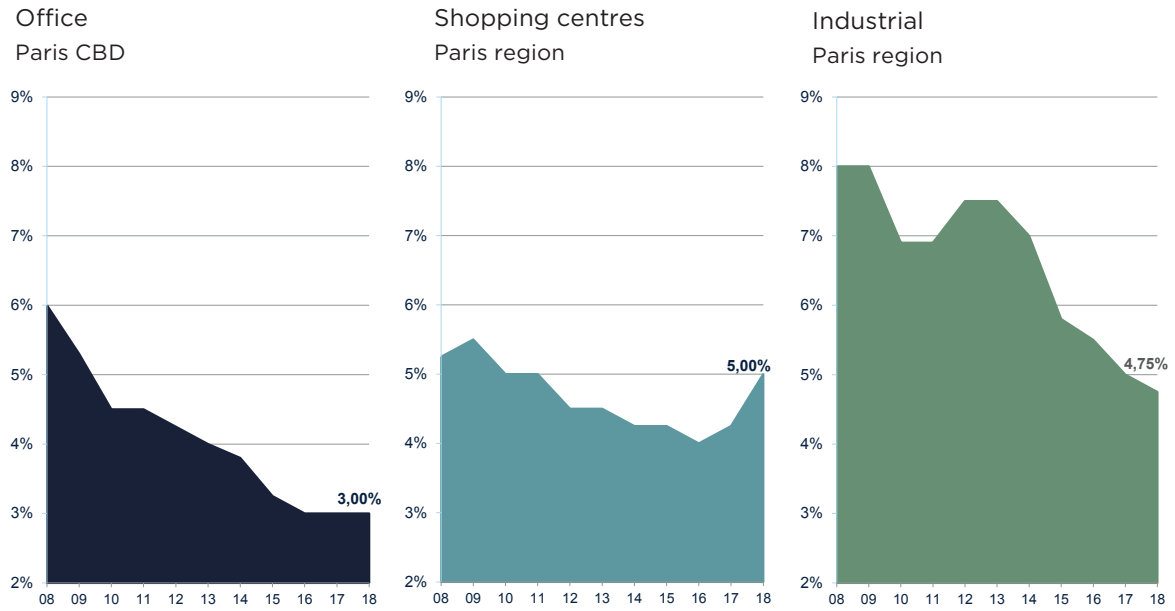
The market thus remains at its lowest historical level. However, such yields are not irrational: in addition to the reversionary potential linked to rental growth, they continue to provide the real estate sector with a high return advantage. The spread with the bond rate thus stood at 231 basis points at the end of December 2018, above its ten-year average (210 bps).

The stabilisation of prime yields, however, does not mean inactivity. Indeed, the yield structure changed during 2018. The interest generated by all available opportunities in the French market, whether in Value Add assets, alternative products, emerging Parisian markets or the regions, gradually affects value differences by reducing certain disparities.

In Paris, for example, the revision of the concept of rental risk leads to the contextualisation of the very notion of Core + or Value Add assets, and encourages the reduction of the spread with the prime category. While this reduction in qualitative differences is reserved for the capital city, 2018 saw a decrease in some prime yields in peripheral areas and in several regional metropolitan areas, again leading to a tightening of the yield structure, this time between areas.

> **Where is the risk in buying a building to be constructed or redeveloped in a market as undersupplied and resilient as that of the Greater Paris Region?**

Prime yields change



Source Savills Research

2019 Outlook
A bright future

The dynamics observed in 2018 are continuing in early 2019. By the end of February, the French investment market had already generated more than €3.5 billion. Several major transactions, some of them involving unit amounts close to or greater than €1 billion, are also in the process of being finalised. While the first half of the year has traditionally witnessed a slowdown in transactional activity and a reduction in investment volumes, all indications are that 2019 will not follow this pattern. The figures for the first half of the year will be good, if not very good.

Beyond the short-term time frame of mid-2019, the sustainability of the European Central Bank's monetary "bazooka" and the announcement of new bank refinancing operations, designed to encourage banks to keep the credit tap wide open, will help to maintain an environment of low interest rates and high levels of financing.

At the same time, investors are concerned about the economic outlook and international instability as they have large amounts of cash to invest. They will therefore continue to seek security. Such an environment is traditionally favourable to bond and real estate investments.

France has regained its appeal, and its real estate market should therefore continue to remain one of the preferred destinations for international investors in Europe. This is particularly the case for German investors: now underexposed in France, they are likely to look to increase their presence there. Value Add and Opportunistic funds, often of Anglo-Saxon origin, are on the lookout for opportunities, attracted by the lack of supply, the resilience of the rental market and the reversionary potential. But this interest in the French market now extends beyond the limits of neighbouring countries or players who are already firmly established there. Korean funds, for example, have a strong appetite and are looking to invest more than €3 billion in France in 2019.

These factors, combined with the strong recovery in the fund raising of French SCPIs and OPCIs, suggest that the market is likely to remain at historically high levels, probably close to €30 billion.

This market context will not be without consequences on yields, nor their structure. A few months ago, it seemed logical to anticipate a slight increase in prime yields, echoing the one expected for bond yields. This rise no longer seems appropriate today. As the spread between real estate and bond yields remains very favourable to the real estate sector (231 basis points at the end of 2018 for an asset located in the CBD), prime rates should remain stable in 2019. Outside the CBD, it may even be possible to see further compression in some emerging markets in the Paris region and in regional markets. The compression of the yield structure, already apparent in 2018, could therefore continue.

This compression could also be reflected in the difference in value of Core+ and Value Add assets compared to Core buildings, provided that they are located in the markets with the least supply. Everything will depend, in this respect, on the continued overall dynamism of the lettings market.

> **"In 2019, the French market is expected to remain at historically high levels, probably close to €30 billion."**

Source Savills Research - Immostat

> **Lyon tire les volumes investis en région Auvergne-Rhône-Alpes et consolide sa place de principal marché régional. Derrière, les Hauts-de-France et la Nouvelle-Aquitaine progressent spectaculairement, grâce au dynamisme de Lille et de Bordeaux.**

Geographical structure of the French market

Something for everyone

As a result of the tradition of French centralisation, 2018 did not deviate from the extreme concentration of volumes invested in the Paris region. Of the €32.5 billion recorded nationally, 72% is attributable to the Paris region (Ile-de-France), equating to €23.3 billion (these amounts do not include the Paris share of the €4.6 billion invested through national portfolios). This dominance is actually on the rise, since in 2017 the Greater Paris Region's share of the sums invested was 69%.

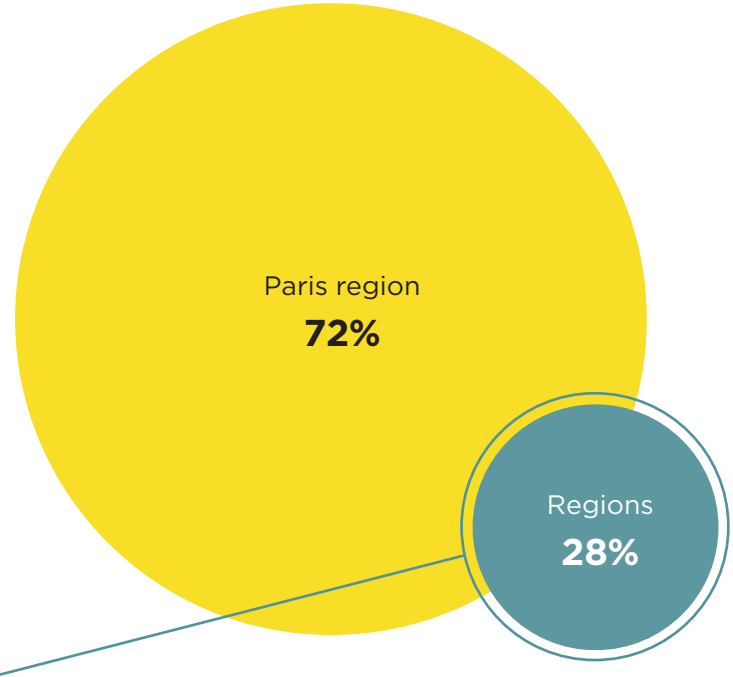
Both the Paris region and regional metropolitan area markets grew in 2018 in terms of volumes invested. While the Greater Paris Region recorded the best performance (+26%) and amounts invested in the regions grew more slowly (+8%), it is worth remembering that regional results were affected by an unfavourable starting point: 2017 figures had been inflated by certain large-scale transactions (starting with the sale of the Logicor portfolio for €1.7 billion) that were exceptional by their very nature.

Driven by the Lyon conurbation, the Auvergne Rhône-Alpes region confirms its traditional position as the main regional market. 1.3 billion euros were invested here in 2018, a significant increase in volume compared to the previous year (+25%).

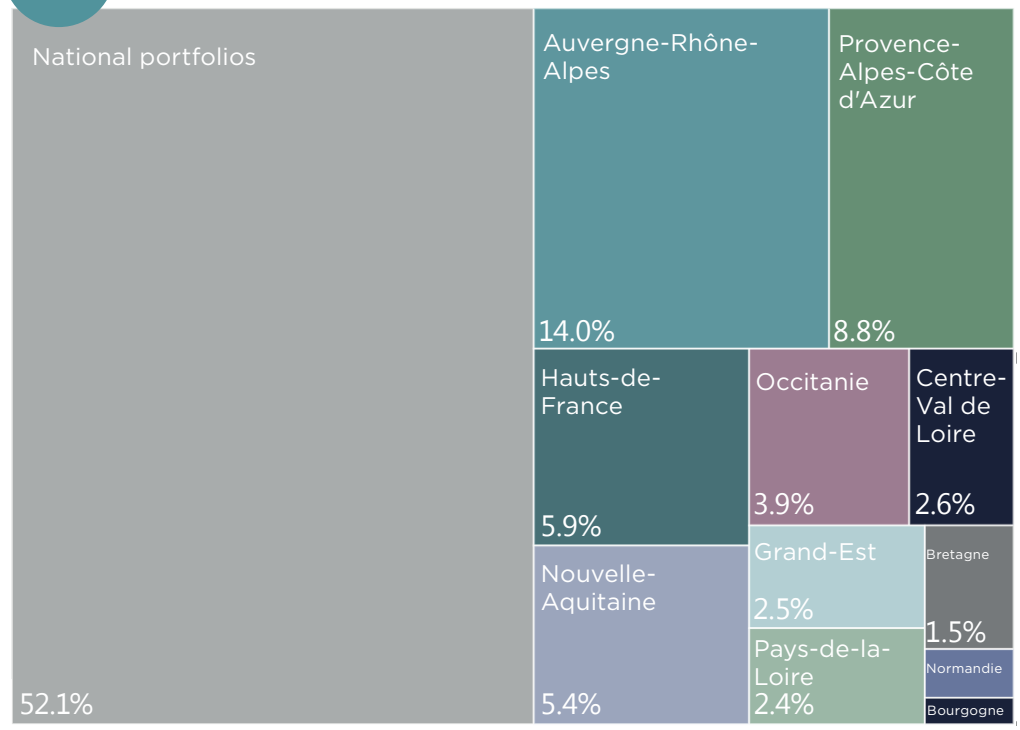
Next in the Top 5 is the Provence-Alpes-Côte d'Azur region (800 million euros), which benefits from the powerhouses of Marseille-Aix and Nice, then Hauts-de-France (540 million) and New Aquitaine (485 million). The latter two regions, which were not in the Top 5 in 2017, made spectacular progress in 2018 with +204% and +189% respectively. Such increases reflect the dynamism and appeal of the cities of Lille and Bordeaux.

In addition to its size, the Greater Paris Region stands out for its very strong concentration in the office sector. With a little over 20 billion euros, this sector represents 86% of investment volumes in the Paris region (an annual increase of 21%). Conversely, the retail sector decreased by 3%, despite buyers' appetite for high street retail assets in prime locations and the completion

2018 : Geographic distribution of funds invested in France

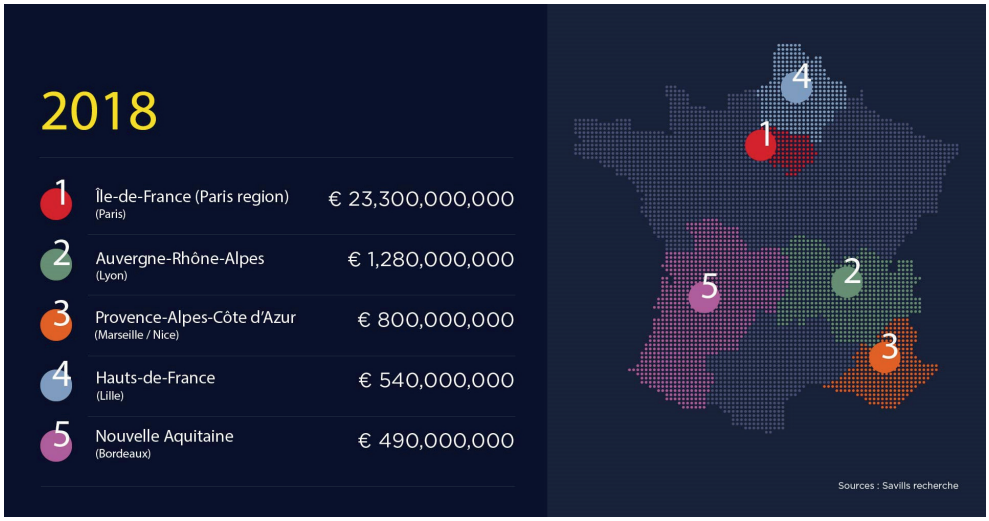


Focus : Geographic distribution of funds invested in regions in 2018



Source Savills Research

2017 & 2018 : Top 5 main French markets

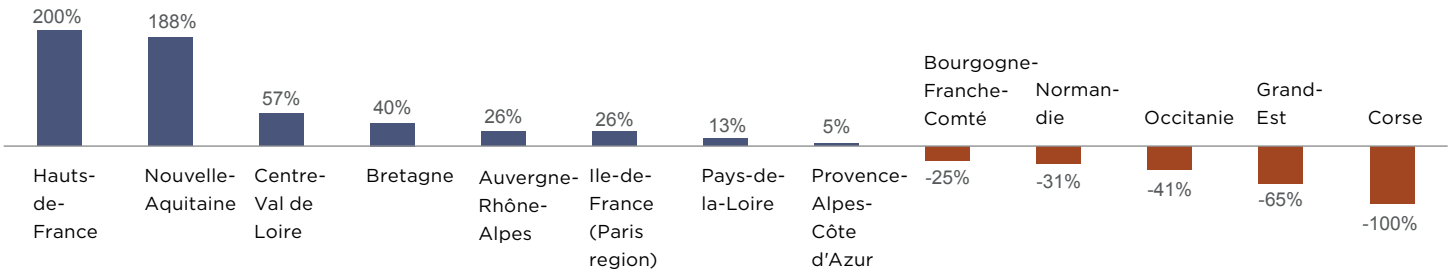


of some large sales, such as that of 114 avenue des Champs-Elysées for more than €600 million. These opportunities were too few to spare retail from its decline and to give it anything other than its usual marginal place in the volumes invested in the Greater Paris Region (6% in 2018). The situation is somewhat different for service-related real estate and industrial (primarily logistics) property which, although only having a small share of the Parisian market (6% and 2% of the investment volumes respectively), experienced a very significant increase in 2018 (+ 220% and + 121%).

Regional markets are much more diversified. Although offices constitute the largest proportion, they account for only 39% of the volumes invested, despite a very strong annual increase (+50% in 2018). Industrial and retail assets each account for 26% of the amounts recorded, a share that is disproportionate to that observed in the Greater Paris Region (despite a decrease of 10% for the industrial sector and a 6% decrease for retail). Service-related real estate accounts for the remaining 9%.

However, there are disparities between regional markets. Auvergne-Rhône-Alpes and Hauts-de-France appear to be much more focused on the office sector, while Provence-Alpes-Côte d'Azur and New Aquitaine owe their success more to the retail sector.

Comparative y-o-y change in investment volumes by French regions in 2018



Source Savills Research - Immostat

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