An overview of the crisis in the French commercial real estate market

MARKET SUMMARY

SEPTEMBER - 2024

LE PODCAST DE CATELLA

Scan this QR code and listen to the interviews with Charlotte Lacoste - Covéa Immobilier, and Nicolas Joly - Icade

INTRODUCTION

- **The outbreak of the Covid-19 health crisis at the beginning of 2020 — as well as the subsequent sudden return of high inflation, and the change in monetary policy in mid-2022 — has led the French non-residential real estate market into an ongoing crisis, the extent of which is currently difficult to determine.** 2023 saw a sudden and very steep drop in investment volume. This downturn intensified in H1 2024: -51% in 2023 and -46% in H1 2024. There has also been a concurrent decline in take-up, (-16% in 2023 and -5% in H1 2024), accompanied by an increase in immediate office supply that has reached unprecedented levels.

  Added to these flagging indicators are questions about a possibly profound market restructuring taking place. This is mainly due to lower demand for office space with the increase in remote working, as well as the cost impacts of green policy-based regulatory constraints, and the obsolescence of a significant amount of office stock.

- **In the past 40 years, the French commercial real estate market has gone through five major crises, each affecting the rental and investment markets to different degrees.** "Crisis" comes from the Greek "*krisis*" and the verb "*krinein*" which means "to sift, sort, or separate grains". Crisis, despite their brutality, should also be regarded as a pivotal moment, redefining the fundamental conditions of both the present cycle and the eventual market rebound.

  In order to better appreciate the contours of the current crisis, we have chosen to take a look in the rearview mirror: **how has the commercial real estate market responded to the different economic cycles since the beginning of the 1990s? What lessons can we draw from these responses to shed light on the current predicament?**

- This re-examination should allow us to take a step away from the fog of the present. Most critically: are we witnessing a natural rebalancing between supply and demand, or a genuine market paradigm shift?

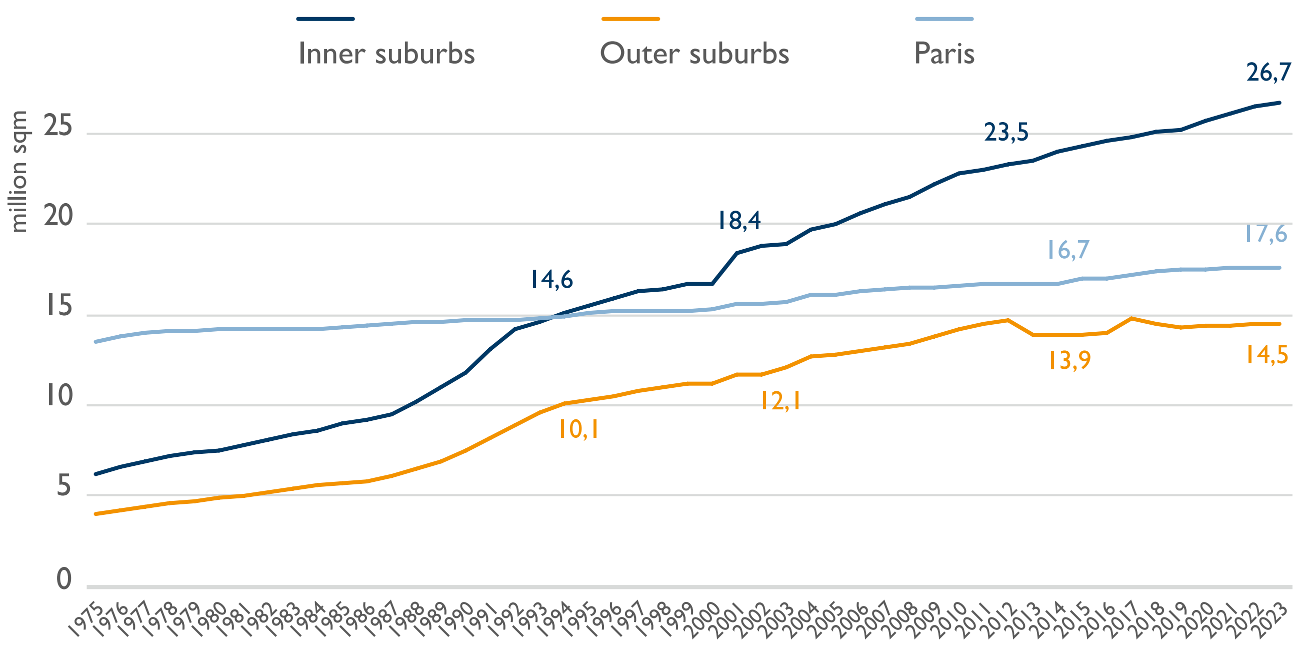
I. THE GROWTH OF A SERVICE-SECTOR BASED REAL ESTATE MARKET (THE 1990s)

A MORE SERVICE-SECTOR BASED REAL ESTATE MARKET BEGAN TO DEVELOP AT THE END OF THE 1980s, EXPERIENCING ITS FIRST MAJOR CRISIS IN 1993

The gradual transition of the French economy, from being primarily based on manufacturing towards the goods and services sector, greatly accelerated in the 1980s. Employment in the service sector, (eg, transport of goods, wholesale trade, business services, etc.), underwent an average annual growth of 1.8% between 1975 and 1982, then jumped to an average of 6.3% between 1982 and 1990. As a result, the office market experienced major growth, with property developers and property traders gradually becoming the key market players. These actors have also greatly benefited from the deregulation of French banks, which have exponentially expanded the range of credit financing services and capitalisation: estimated at 25 billion francs in 1982, capitalisation reached 350 to 450 billion francs in 1992.

In Île-de-France, the main areas of office building concentration have rapidly gone from being very Paris-centric, to also including a wide range of nearby suburban business districts. Beginning in the early 1980s, large-surface office projects multiplied: in addition to the refurbishment of many very large buildings in Paris, (the so-called "ocean liners"), construction increased considerably in Hauts-de-Seine, with the office stock in the inner suburbs experiencing such rapid growth that, in 1992, it surpassed that of Paris. In this pivotal period between 1985 and 1991, real estate speculation was at its height, with rental values and sales prices increasing very sharply.

Growth of Île-de-France office stock by submarket: 1975-2023



— Source : MBE Conseil / ORIE

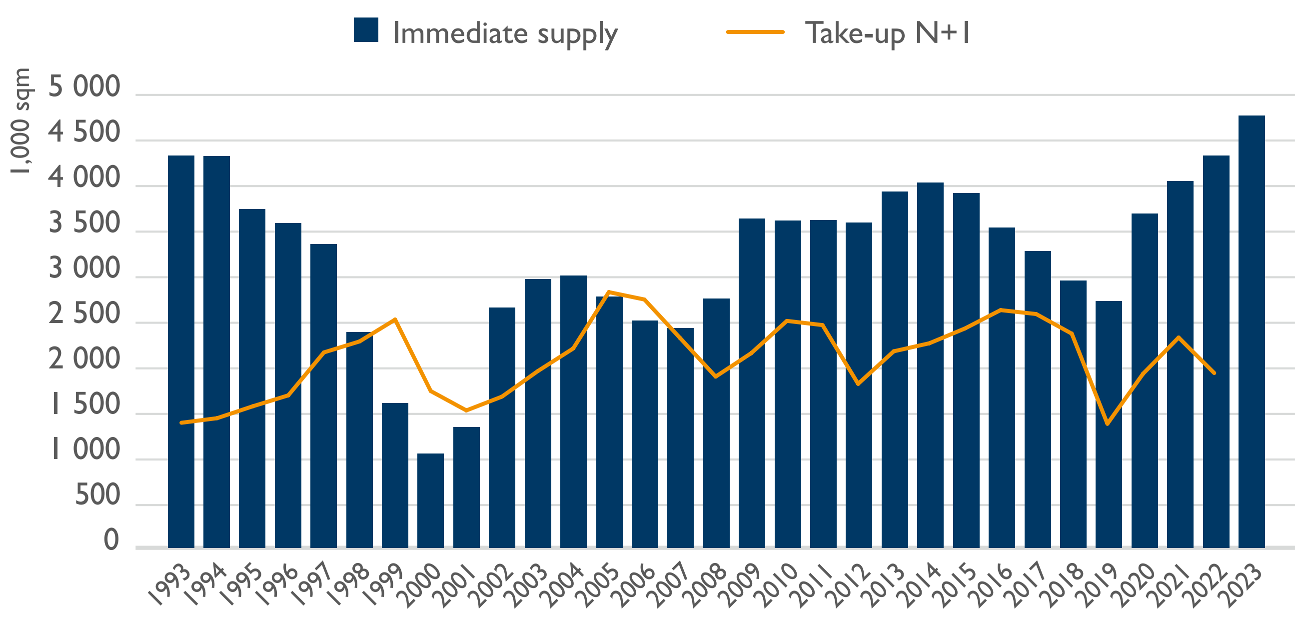
In 1991, the First Gulf War triggered a crisis that would severely impact commercial real estate markets globally. France, hit hard by a fall in exports and high consumer debt, entered recession at the end of 1992. This decline in growth continued in 1993: GDP fell by 0.6% and employment by 0.9%. Rising unemployment, falling purchasing power and persistently high real interest rates weighed very heavily on the residential market, with the number of transactions in Paris falling by 40% between 1991 and 1992.

Compounding this dire situation, the European monetary system as a whole underwent a major crisis. In September 1992, several European currencies were attacked by speculators: the British pound and Italian lira were withdrawn from the European Exchange Rate Mechanism (ERM), and the Spanish peseta was devalued. It was also after the summer of 1992 that the crisis in French commercial real estate worsened, following the release of poor bank results and the successive announcements of various developer "rescue plans". **It is worth noting that this major crisis was indeed global: from New York to Tokyo as well as in Paris and London, office markets were collapsing, victims of the economic slowdown, with sharp drops in transaction activity, in a speculative context where many projects were launched in anticipation of a strong growth in rental values that failed to materialise.**

While obviously hitting developers hard, banks were not spared the ill effects of the crisis, accumulating unmanageable amounts of bad debts. Nor were institutional investors, whose office buildings struggled to find tenants. **Although take-up in Île-de-France exceeded two million sqm in 1990 for the first time, this dropped by half in 1992.** As a result, **office oversupply was severe, with immediate supply exceeding 4.3 million sqm in 1993,** half in the form of new or renovated offices. Several major ZAC projects were temporarily halted, such as ZAC Bercy and Paris Rive Gauche in Paris, and the ZAC Bords de Seine in Issy les Moulineaux, where a few major projects were cancelled.

The non-residential investment market of the early 1990s was small by current standards, with influx between 1986 and 1990 barely peaking above 5 billion euro. **Proportionally, however, the fall in investment in 1993 was significant: investment volume fell by 80%, barely reaching 900 million annually at its low point.**

Immediate supply and take-up in Île-de-France: 1993-2023



— Source : MBE Conseil / Immostat

The 1993 crisis was profound and its after-effects were long-lasting. Office-related projects were scarce until 2000, with take-up not returning above the 1.5-million-sqm mark until 1996.
However, economic recovery was solid between 1997 and 2000, boosted in particular by the rise of new information technologies. Eight years passed between the lower point in the cycle and its peak in 2000. At this latter date, 2.5 million sqm of office space were transacted in Île-de-France, with immediate supply falling to the lowest level seen at any point in the past 30 years, at barely more than a million m².

The year 2000 also saw a profound transformation in both the size and the nature of the non-residential real estate market: a direct result of the 1993 crisis. On one hand, many institutional investors withdrew from the office market in the wake of the crisis. On the other hand, banks began to implement so-called "financial defeasance structures" that year. These new initiatives initially attracted **American funds managed by banking structures, with independent funds soon following suit.** These investors took advantage of the fall in the cost of debt, as well as of transfer taxes on offices and commercial buildings (introduced in 1999), to buy back a significant number of assets, thereby enhancing the investment market as a whole.

Major events and developments:

- The French non residential real estate market experienced a profound transformation from that of the 1970s and 80s, with the emergence of a more service-sector based economy generating far higher demand for offices.
- Market growth in Île-de-France was mainly driven by the extensive development of offices in the inner suburbs of Paris, and the creation of business centres both within and outside the capital.
- The First Gulf War (August 1990-February 1991) caused an energy crisis, which served as a trigger for a global economic recession.
- An oversupplied office market was hit by a very steep drop in demand. In 1993, immediate supply was three times higher than take-up in Île-de-France.
- The decline in investment in commercial real estate was drastic and the crisis was profound: it took nine years to return to 1989 investment volume levels.

II. THE FINANCIALIZATION OF COMMERCIAL REAL ESTATE AND TWO STOCK MARKET CRASHES (THE 2000s)

2001 - 2002: BURSTING OF THE INTERNET BUBBLE AND STOCK MARKET CRASH

During the early 2000s, the growth of new Internet technologies fuelled stock market growth, with the CAC 40 reaching an unprecedented high of nearly 6,945 points in September 2000. However, the subsequent "internet bubble burst" occurred during a period of major bankruptcies, with global telecom firms, as well as major multinationals in different sectors such as Enron and Arthur Andersen, going under. **In March 2003, the CAC 40 plummeted to 2,401 points.**

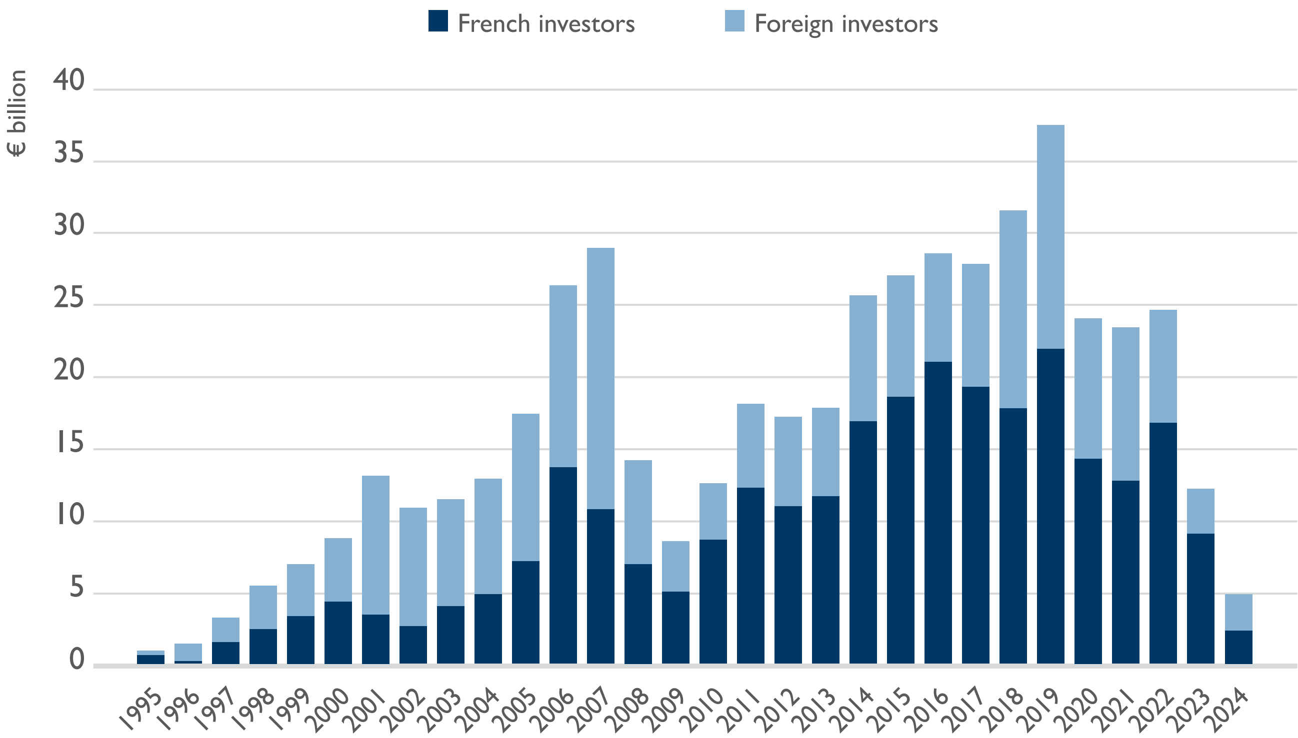
Economic growth was curtailed in France, dropping from +2% in 2001, to +1.1% in 2002, then to +0.8% in 2003. Employment growth also slumped, from +1.1% in 2001, to -0.2 % in 2002, then to -0.9% in 2003. **However, the French economy did not enter into recession and, unlike in 1993, the 2002 crisis affected the rental and investment markets quite differently.**

Take-up for offices fell by 31% between 2000 and 2001, then by 12% in 2002, confirming the existence of a direct link between economic growth, employment levels, and office transactions. At the same time, **immediate availability of offices started to rise again.**

Unlike in 1993, no oversupply weighed on the market. On the contrary, there was a severe shortage, with the overall vacancy rate in Île-de-France at 2.4% in 2000, and only 1.1% in Paris. The drop in take-up volumes (1.5 million sqm) was also less than in 1992 (1.1 million sqm).

The investment market, however, was not affected by the crisis: influx reached €13 billion in 2001 and remained above the €10-billion mark in 2002 and 2003. Foreign investors were the primary market players, most notably American and German funds and real estate companies. The early 2000s were notable for a series of very high-value sale&leaseback portfolio transactions, such as the acquisition of 40% of France Telecom's assets in 2001 by Goldman Sachs and GE Capital for nearly €3 billion. In a severely undersupplied office market, speculative investments also grew substantially, reaching more than €3.6 billion cumulatively in France in 2001 and 2002.

Commercial property investment volumes: French vs. foreign investors (1995 – 2023)

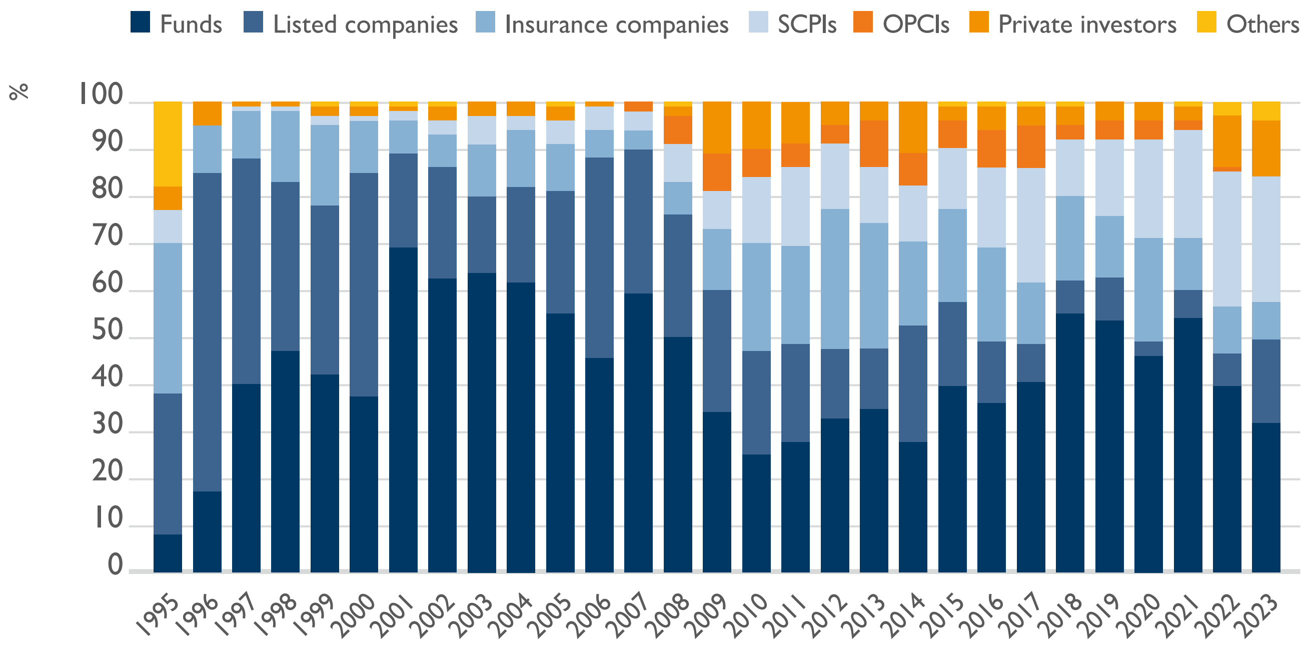


— Source : MBE Conseil

The economic recovery following the dot.com crash was moderate, but take-up for offices in the Île-de-France region returned to growth quickly; only four years passed between the bottom of the cycle in 2002 and the next cycle peak in 2006. In the latter year, transaction volumes reached **a historic peak of 2.8 million sqm,** a level nearly matched in 2007 (2.7 million sqm). The resumption of speculative investment and the development of large office buildings on the outskirts of Paris were major market stimulants, the latter allowing companies to rationalize their real estate space and cost considerations in the face of a significant growth in headline rents in many more central locations. In 2006, large-surface office take-up represented 73% of total transaction volume, or nearly 1.2 million sqm.

Over this same period, between 2003 and 2007, the investment market expanded notably: financialization continued its growth, aided by low interest rates and more capital becoming available for real estate. Market maturation accelerated further in 2003, with the creation of the SIIC (listed real estate investment company) model. The number of such companies increased from ten in 2003 to 40 in 2006. The cumulative amounts invested by SIICs over the 2003-2007 period reached €25.1 billion, with a further €53.6 billion in market influx from foreign funds. **Volumes invested in non-residential real estate in France grew strongly during this period, reaching €28.7 billion in 2007.** It should be noted, however, that, **beginning in 2006, office prime yields indicated a speculative risk**: in Parisian submarkets, the gap between prime yields and ten-year bonds narrowed sharply (27 basis points), with discrepancies among the different submarkets becoming narrow.

Investment volume by major investor type: 1995 - 2023



— Source : MBE Conseil

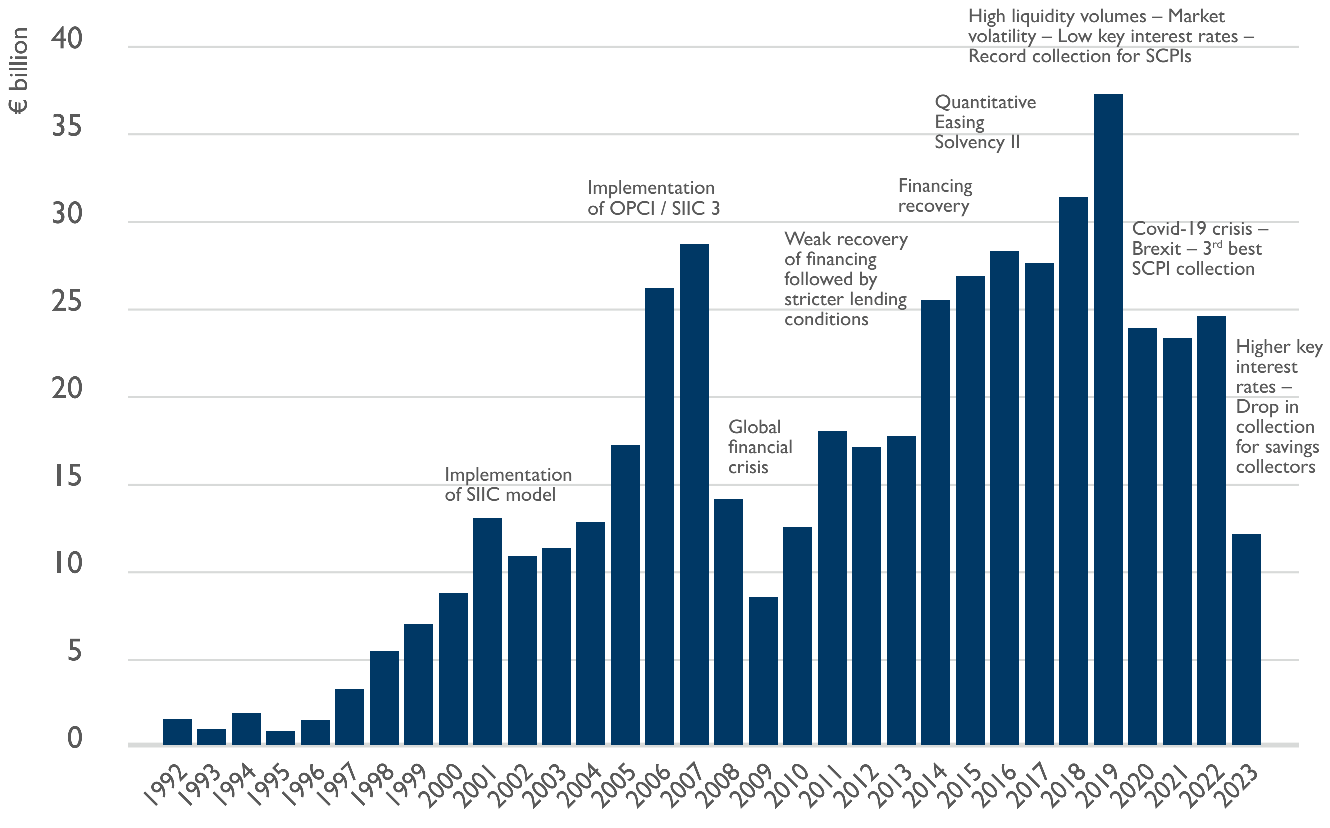
2007 - 2009: THE FINANCIAL CRISIS CREATES MAJOR GLOBAL TURBULENCE, HITTING THE FRENCH COMMERCIAL MARKET HARD

Although 2007 marked a peak for commercial property investment in France, the American subprime crisis began to send shockwaves through the global economy that year. The summer of 2007 saw a major drying up of interbank liquidity, as well as a drastic reduction in the willingness of banks to extend credit. This very severe crisis, however, coincided with an excellent performance by the French office rental market, and an overall increase in rental values. Investors, still having a high volume of liquidity available for real estate, largely favoured this sector over the financial markets that were already suffering due to the crisis.

A fuller appreciation of the seriousness and depth of the crisis only arrived quite late, with the September 2008 bankruptcy of the Lehman Brothers investment bank, a Wall Street titan, signalling the true extent of the subprime crisis. The severe recession in the US had an inevitable knock-on effect in European countries, reaching France at the end of 2008.

Salaried employment in France fell by 0.6% between 2007 and 2008, then by 0.9% in 2009. GDP growth declined by 2.9% in 2009 from +0.3% the previous year. **The recession naturally had a drastic impact on the Île-de-France office rental market, with a 15% drop in transaction volumes in 2008 (2.3 million sqm) a situation that worsened in 2009, when 1.9 million sqm were transacted (-17%). The immediate supply of offices increased in 2009, with the overall Île-de-France vacancy rate reaching 6.9%** (5.7% in Paris and 7.4% in the suburbs).

Commercial property investment volumes

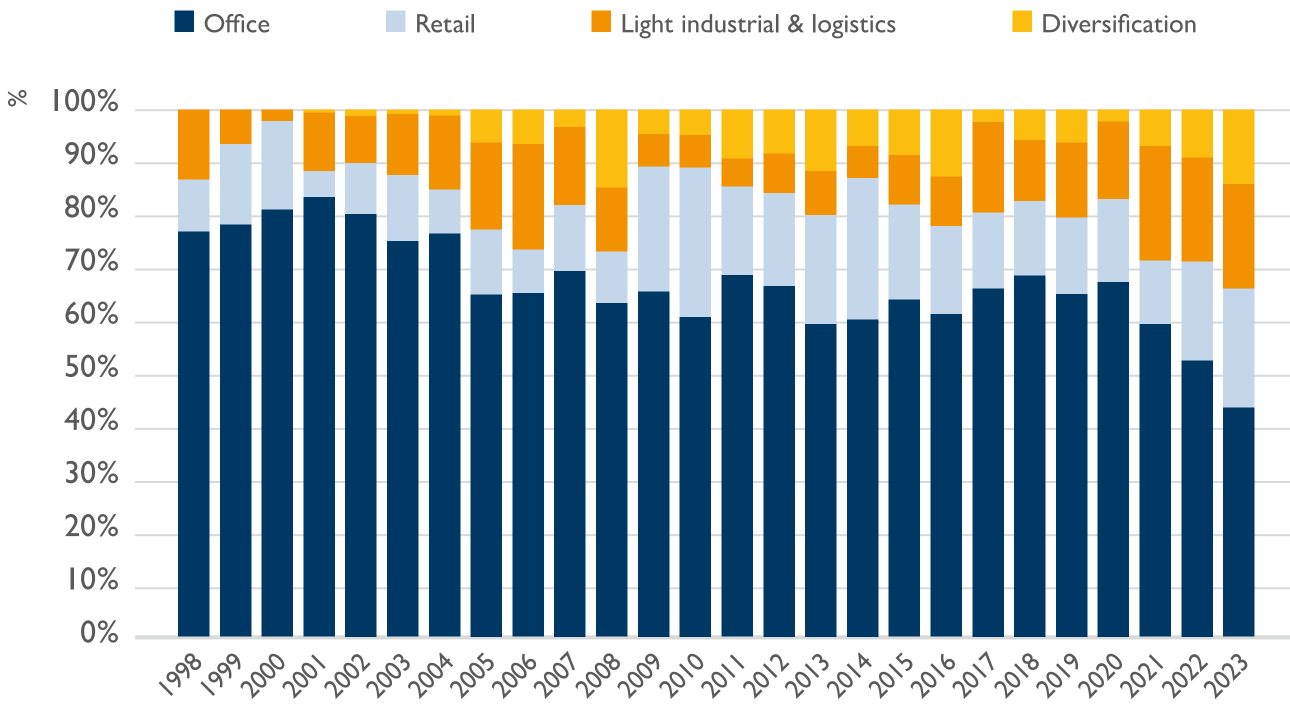


— Source : MBE Conseil

The impact of the financial crisis was much stronger in the investment market, which declined violently in 2008, with only €14.1 billion being invested (-51% from 2007). The fall in interbank liquidity and fewer bank refinancing possibilities, as well as the tightening of credit conditions, led to a sharp drop in the debt ratio: on average 80% in 2007 vs 50% in 2008. Market turmoil heavily impacted opportunistic funds and real estate companies, which also suffered from the stock-exchange downturn. The number of high-value transactions, which are typically more difficult to finance, fell sharply.

As with the rental market, however, it was in 2009 that influx plummeted most substantially. Volume barely reached €8.5 billion, with investment in retail assets accounting for 28% of volume: more than €2 billion. **Offices remained the favoured asset type, but influx in this asset class fell from €20 billion in 2007 to only €5.5 billion in 2009.** Foreign investors invested €18.1 billion in 2007, including €6.6 billion by American, €3.2 billion by British and €3.1 billion by German investors. **In 2009, foreign investors only accounted for €3.5 billion,** including €1.7 billion by Germans. French investment was halved between 2007 and 2009, dropping to only €5 billion, including €1.7 billion on the part of real estate companies, (mainly SIICs). Burdened by the credit crunch, transactions valued at more than €100 million fell dramatically: in 2009, there were only 14 transactions in this range, totalling €2.7 billion, compared to 73 transactions for €17 billion in 2007.

Investment volume by asset type: 1998 - 2023



— Source : MBE Conseil

Major events and developments:

- The gradual financialization of commercial real estate resulted in regulatory changes (eg., creation of the SIIC model in 2002, OPCI and SIIC 3 in 2007) and the rise of foreign investors.
- Real estate became an asset class in its own right. Commercial real estate expanded strongly: average investment volumes from 2000 to 2010 were five times higher than in the previous decade.
- Commercial real estate benefited from a favourable economic environment: low financing costs, outsourcing of real estate functions, changing trends in tenant behaviour (ie., rationalization of office space needs) and more limited office availability.
- Both "crises" of the period had an externally generated financial trigger. The repercussions of the subprime crisis were more severe than those of the dot.com crisis, because real estate was more financialized and the debt leverage on acquisitions was often high.
- While investment volumes and take-up were both impacted, the low point of these cycles was reached relatively quickly (two years), and also rebounded quickly (two years).
- In the face of heavy stock market turbulence, non-residential real estate proved itself a resilient diversification asset.

III. A SAFE HAVEN WITH PERFORMANCES BOOSTED BY LOW RATES (THE 2010s)

2010 – 2013: AN ECONOMIC SLOWDOWN DURING A SOVEREIGN DEBT CRISIS IN EUROPE: THE RENTAL MARKET IMPACTED; INVESTMENT STIMULATED

The after-effects of the financial crisis of 2008-2009 soon collided with the sovereign debt crisis in Europe, affecting Greece and Ireland in particular, and led to a continent-wide stock market crisis in 2011. Austerity policies were put in place in all member countries of the European Union, weighing on growth prospects. In France, GDP growth fell from +2.2% in 2011 to +0.3% in 2012 and +0.6% in 2013. Employment also suffered, stagnating in 2012 and growing by only half a point in 2013.

The effects on the office rental market, however, were not as negative as during the 1993 crisis. From 2010, take-up resumed trending higher, again exceeding 2 million sqm in 2011 and 2012. Once again, large-space rental transactions drove the market, in accordance with the real estate rationalization objectives and cost-saving strategies taken by many major tenants. Thanks to the resilience of the rental market, as well as to the low number of construction starts during the crisis, the rise in vacancy rates was moderate.

In 2013, however, the rental market experienced a sharp drop in take-up activity (-25%), linked to the plunge in large-surface transaction volume. Vacancy rates rose in certain areas, but future supply volume remained under control.

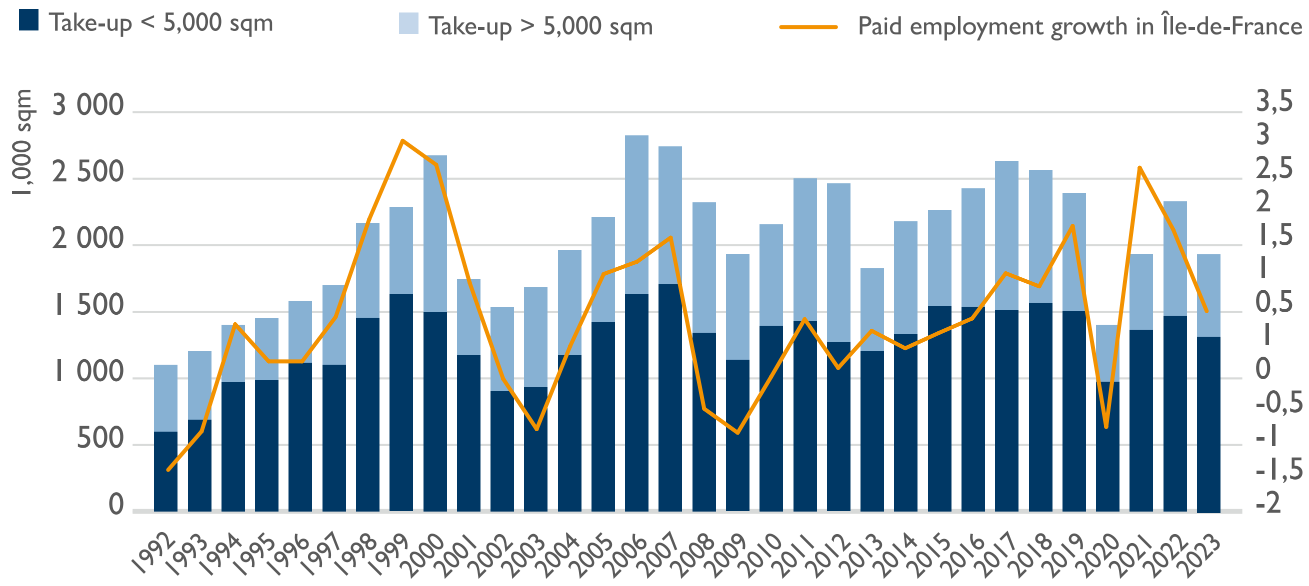
In the investment market, however, the impact of the sovereign debt crisis had quite the opposite effect. Beginning in 2010, there was a resumption of investment (€12.5 billion) which intensified in 2011 (€18 billion) and remained between €17 and €18 billion in 2012 and 2013. Financing conditions remained restrictive until 2012, but low bond yields and the instability of financial markets helped to return real estate to "safe haven" status. Furthermore, the investment market was boosted by the appearance of new opportunities, due to the 2012 expiry of the capital gains tax and the sale by German funds of part of their assets held in Île-de-France to reimburse shareholders. Consequently, while funds became less active, insurance companies, SCPIs and real estate companies became larger market players.

In 2013, although take-up fell sharply, the investment market remained dynamic, stimulated by continued high liquidity for real estate and more favourable lending conditions.

2014 – 2018: RENTAL MARKET RECOVERY AND MARKED GROWTH IN INVESTMENTS

2014 to 2018 were years of recovery for both the rental and the investment markets. The growth in salaried employment levels was initially subdued, then accelerated in 2017 and 2018, as did the growth in GDP (between +1 and +1.1% between 2014 and 2016, rising to +2.3% in 2017, then to +1.9% in 2018). **Always closely linked to prevailing economic trends, take-up only peaked in 2017 and 2018. High take-up also led to a continued reduction in office supply: in 2018, only 2.9 million sqm were immediately available**, a drop in immediate supply of 32% compared to 2014, with an overall vacancy rate in 2018 of only 5.2% for Île-de-France and 2.2% for Paris. It should be noted, however, that available supply during its historic low point in 2000 barely exceeded 1 million sqm, and that **the Île-de-France rental market has significantly matured over the last two decades: stock in 2018 stood at 53.5 million sqm, compared to 40.6 million sqm in 2000.**

Office take-up and paid employment growth in Île-de-France

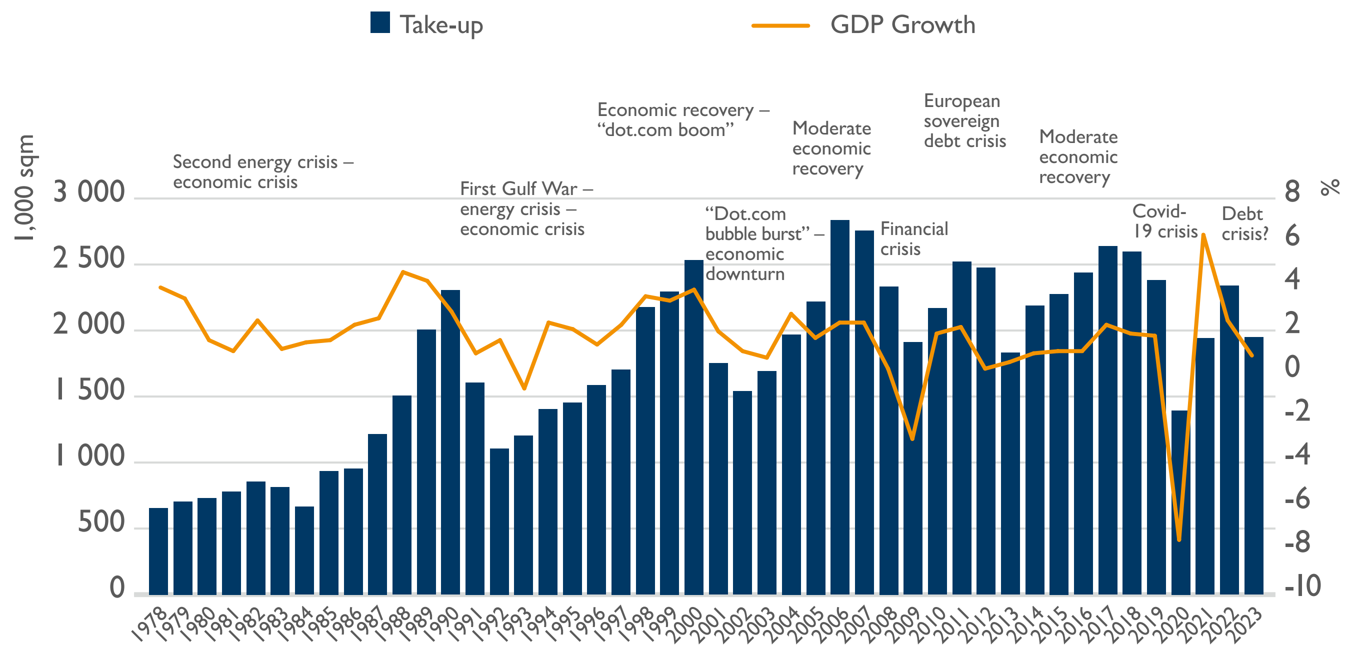


Source : MBE Conseil / Immostat / INSEE

It should also be noted that growth in the investment market during this period was largely disconnected from that in the rental market. While, from 2014 to 2016, the increase in take-up was restrained by sluggish economic growth, **the investment market grew by 44% between 2013 and 2014. Moreover, the increase in volumes invested in non-residential real estate was almost continuous, until reaching its peak of €31.4 billion in 2018.** In 2014, the ECB began its quantitative easing policy, intended to continue until inflation increased to 2%, leading to a sharp drop in government bond yields. At the same time, banks resumed an interest in the real estate financing market and, against a backdrop of mediocre stock market performance, low bond yields and poor Livret A returns, the collects of real estate companies, as well as SCPIs and OPCIs, grew strongly.

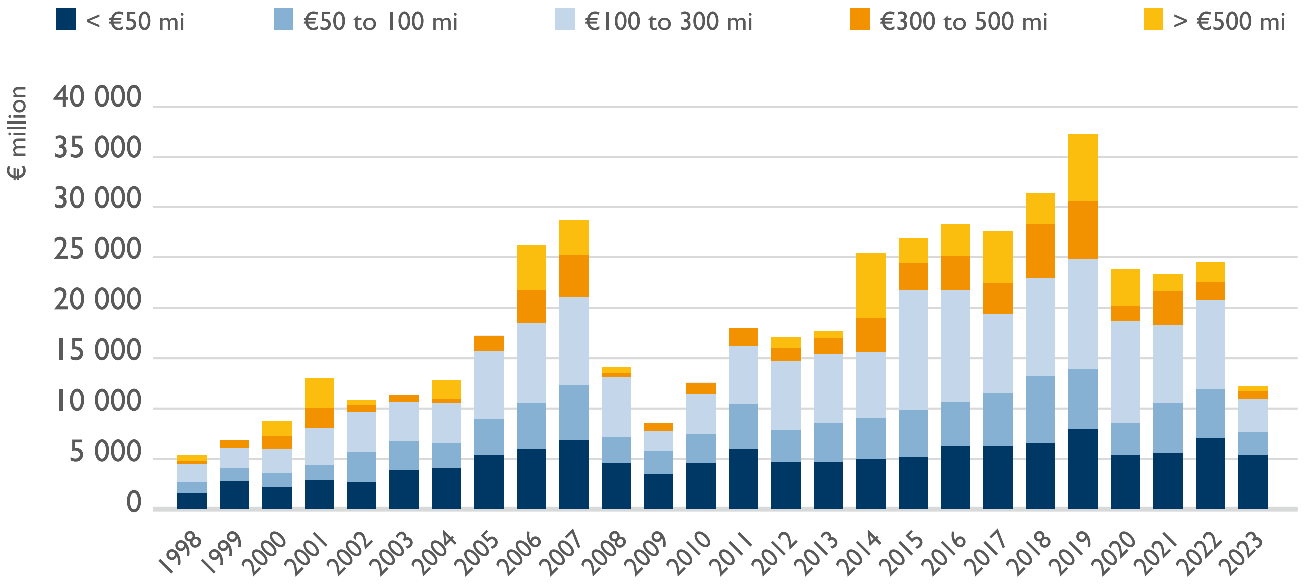
The increase in liquidity for investment funds and savings collectors continued in the following years. This greatly contributed to the growth of investment, also boosted by the vitality of the rental market in 2017 and 2018. (This trend also helped to enable the growth in speculative investment, mainly in offices, which peaked in 2017.)

Office take-up in Île-de-France and GDP growth: 1978 – 2023



Source : MBE Conseil / Immostat / INSEE

Investment volume in commercial real estate by asset value: 1998 - 2023



— Source : MBE Conseil

AN END OF THE CYCLE ANTICIPATED AS EARLY AS 2017, BUT RECORD INVESTMENT IN 2019

A real paradox of this recent period is that the euphoria of the rental and investment markets in 2018 raised serious concerns, starting in 2017. Many analysts began to fear the outbreak of a new financial crisis, resulting from an overheated market created by overabundant liquidity. At the end of 2017, the US Federal Reserve decided to gradually wind down its quantitative easing policy and raised its key rates by a quarter of a point, in the face of a greater than expected rise in inflation.

Adding to these fears in 2018 were growing concerns about the global geopolitical situation: namely, mounting antagonism between the United States and China, a slowdown in the Chinese economy, Brexit and the global rise of populism.

Against this backdrop, 2019 represented a respite, with GDP growth in France of +1.2% and relatively positive economic indicators, particularly regarding employment. As a result, take-up fell by only 10%, to almost 2.4 million sqm. Vacancy rates also continued to decline, with undersupply worsening in Paris.

The investment market, however, once again far outshone the rental market, with an increase in volumes for the tenth consecutive year, reaching an annual record of €37.3 billion. With a systematic use of credit thanks to still-low interest rates, exceptional collections for savings collectors, and increased fundraising on the part of private investment funds, this influx of liquidity also coincided with the arrival on the French market of various foreign investors, particularly Asians, who were turning away from the British market due to Brexit. **2019 also proved a record year for transactions valued at over €500 million: €7 billion were invested in this asset range, including two transactions valued at more than €1 billion.**

Despite this excellent performance, concerns that had first been voiced in 2017 about a potential major market correction persisted, **following an upward trend of four years for the rental market, and ten years for the investment market.** There was a general consensus among analysts at the end of 2019 that some sort of disruptive event could end this cycle. In the event, this took the highly unexpected form of a global health crisis.

Significant events and developments:

- Commercial real estate benefited from a new macroeconomic situation: the depreciation of yields on "risk-free" assets (treasury bonds, Livret A books, bonds) and the positive effect of cheap credit.
- The European sovereign debt crisis weighed heavily on growth, and therefore on employment and demand for offices. However, the response of the European Central Bank (ie, quantitative easing) benefited commercial real estate, creating a climate conducive to increased investment volumes and new construction.
- Commercial real estate became favoured by investors, who saw an attractive return/risk balance. Insurance companies, along with SCPIs and OPCIs, were among the most active investors during this period.
- Faced with the volatility of the stock markets, real estate benefited from its reputation as a "safe haven", offering strong returns.
- Real estate returns over the period were boosted by key interest rates being at historically low levels, with rental values sometimes being artificially maintained through incentives.

IV. A MULTI-FACETED CRISIS (2020 – PRESENT)

2020 – PRESENT: THE GREAT UNCERTAINTY

While the Covid-19 health crisis naturally led to a sharp drop in take-up and investment influx, it may also have offset many of the constraints and risks that had burdened the non-residential real estate market before the shock of 2020 (and which might have become worse).

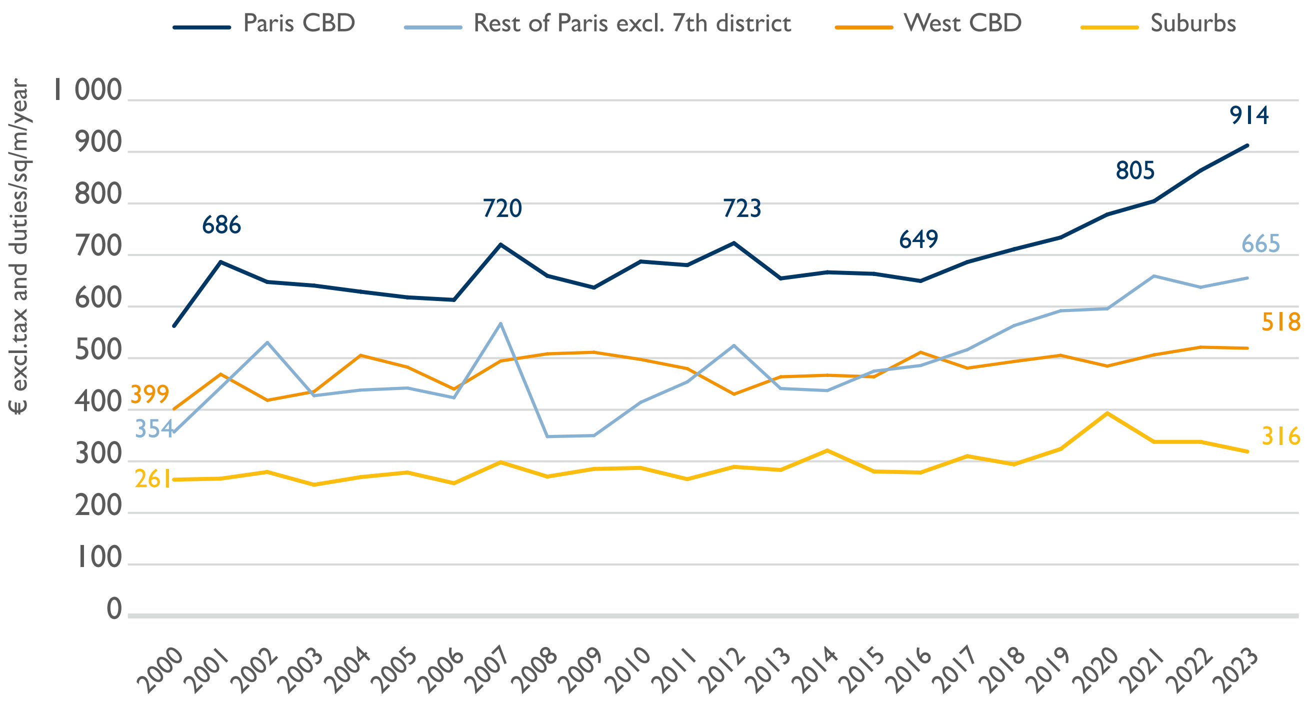
Transaction volumes have been erratic since the end of the health crisis. There was weak recovery in 2021, (due to some confinement policies being still active), then improvement in 2022, where take-up volumes returned to the two-million-sqm mark, before a new, moderate decline in 2023 (1.9 million sqm). **The profound change in working habits is often put forward to explain this drop in demand, linked to the reduced need for office space due to the continued trend in remote working. However, it is perhaps still a little too early to truly appreciate the full extent of this trend's impact.** Nevertheless, the longstanding correlation between GDP growth and growth in salaried employment is still confirmable, with GDP growth reaching +6.4% in 2021 (reflecting a catch-up effect during a year still partially affected by confinements and lockdowns), +2.5% in 2022 (in line with the increase in take-up), and only +0.9% in 2023. Employment followed a similar trend: +2.7% in 2021, +1. 9% in 2022 and +0.8% in 2023.

However, present market difficulties extend beyond the crisis in take-up, which should rebound if economic growth and job creation rates improve. We are also currently witnessing a new crisis of supply: in the Paris region, office stock grew by 94 % between 1987 and 2023, with a long-term take-up average of 2.2 million sqm and an average over the past ten years of 2 million sqm. Consequently, in a regional market where speculative investment has greatly increased and where new business districts have multiplied, **the delivery of new supply – combined with an abundance of releases - has led to a very strong growth in available office space: nearly 5 million sqm in Q2 2024. A retrospective analysis of the real estate crises shows that, apart from in 2000, when immediate supply fell to only 1 million sqm, the level of net absorption after subsequent crises was of a much smaller scale: in Île-de-France, immediate supply fell, at most, to 2.7 million sqm in 2019.**

A mature market par excellence, the Paris Central Business District (CBD) has never endured oversupply and has always held exceptional appeal for businesses. However, we presently detect a discrepancy compared to previous crises; historically, rental values in the CBD have adjusted to boost its attractiveness for businesses. However, since the post-Covid resumption of take-up activity, the Parisian markets – and the Paris CBD in particular - have accounted for a growing proportion of transactions, despite a significant overall increase in rental values. **One explanation for this phenomenon perhaps lies in the significant increase in inflation over the past three years. When adjusted for inflation, rises in average new office property values have actually been relatively modest in Paris, including in the CBD. Conversely, a relative drop in average values for new properties, (in constant euro values), is evident in most of the business districts in the Île-de-France region.**

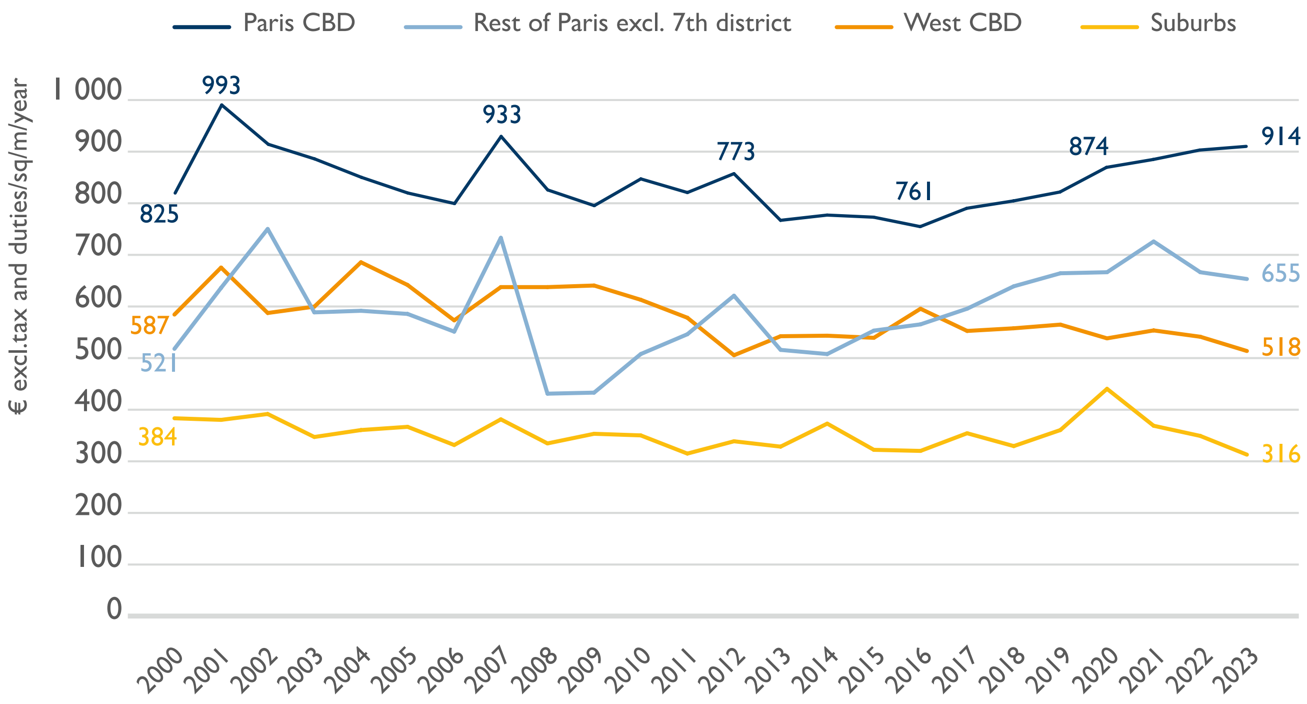
Consequently, take-up patterns in the near future will undoubtedly be most influenced by a rebound, (or a slowdown), in GDP growth and employment. However, we have seen that typically, in periods of market crisis, large-surface transaction growth can help sustain the overall market when the small and medium-space markets are weaker, due to many tenants seeking lower rents and space rationalization. If this trend is repeated in the current crisis, the widespread continuation of remote working might not only have an impact on the amounts of space needed, but might also trigger movements for companies seeking space rationalization.

Average values for new office buildings by Île-de-France submarket (in current euros): 2000 - 2023



— Source : MBE Conseil

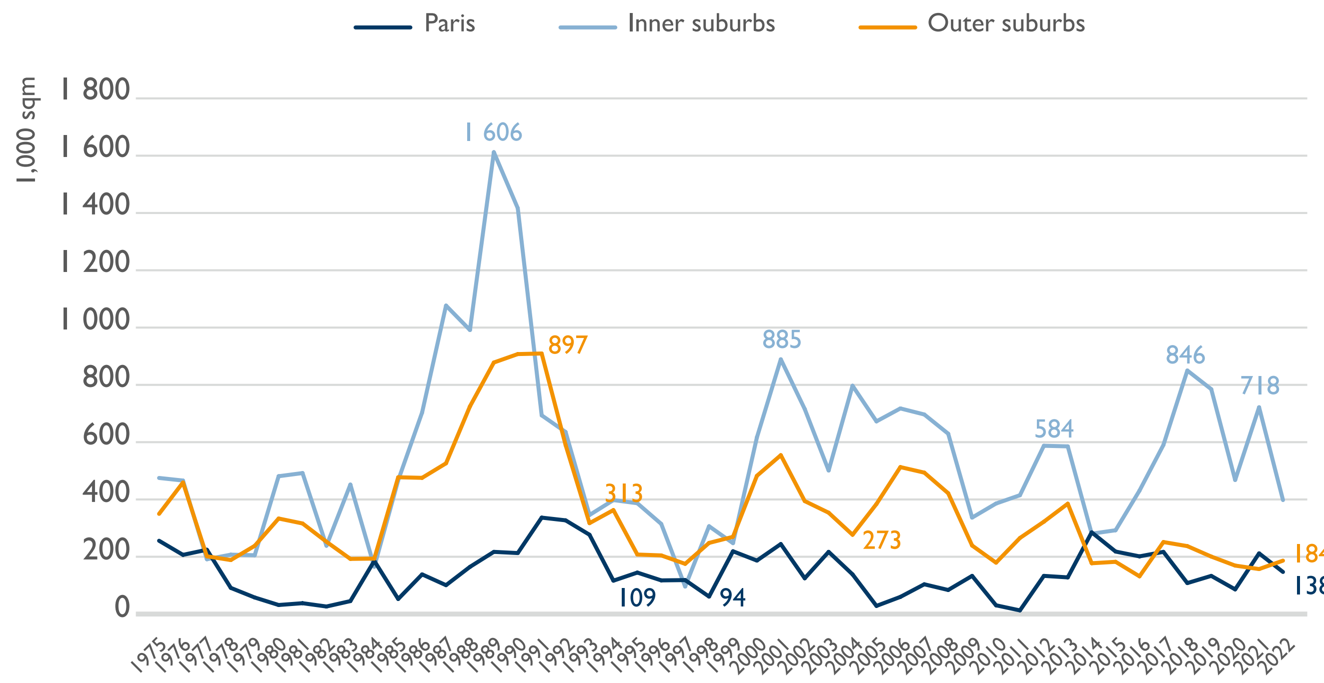
Average values for new office buildings by Île-de-France submarket (in constant euros): 2000 - 2023



— Source : MBE Conseil

The investment market has changed in scale in the wake of the Covid-19 crisis. However, unlike the situation affecting take-up levels, it has not experienced a collapse, with influx remaining above €23 billion over the 2020-2022 period.
Paradoxically, in 2020, speculative investment actually increased by 19%, exceeding €3 billion, mainly due to the finalization of many deals that had been initiated pre-Covid. These transactions have contributed to maintaining a high level of construction starts, and also to the high delivery rate of new offices, which have been a major feature in Île-de-France supply over the last three years.

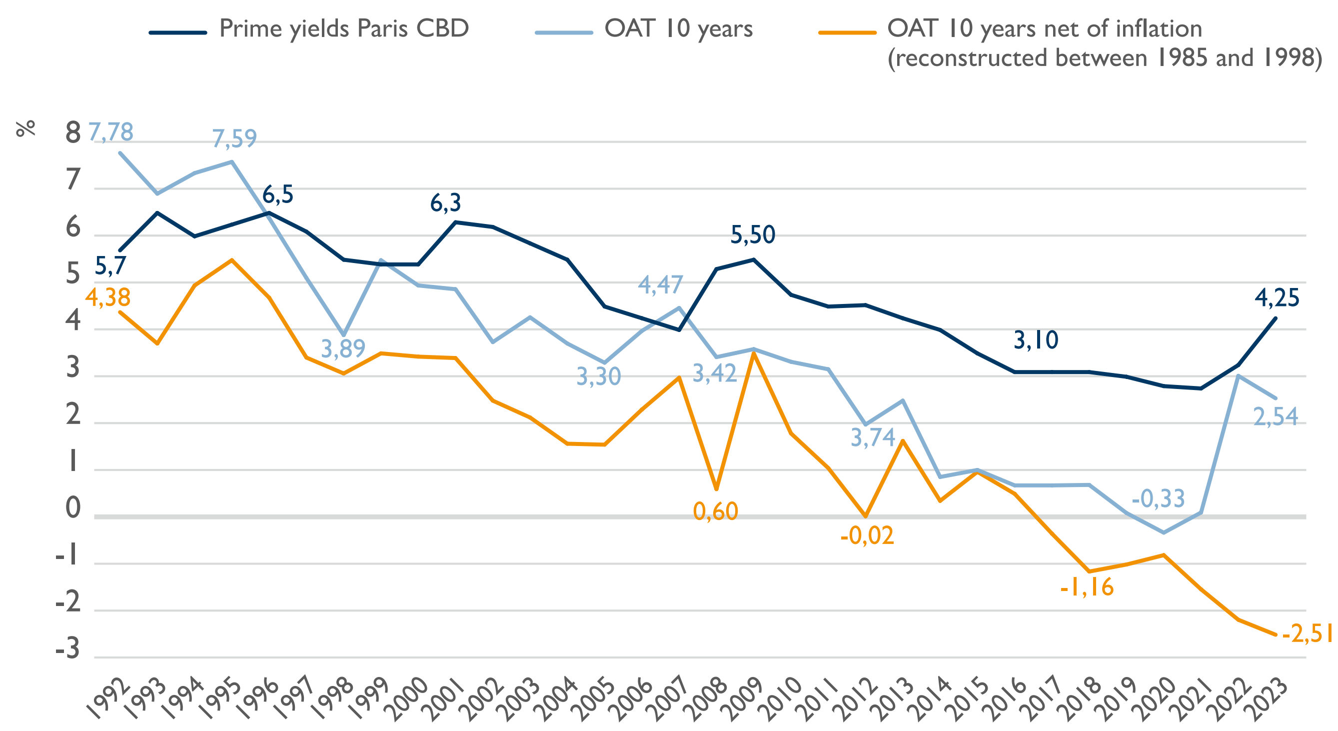
Office construction starts in Île-de-France: 1975 - 2022



— Source : MBE Conseil / SITADEL

The real market turnaround with regard to investment occurred in mid-2022, when, faced with renewed inflation, the ECB took the initiative of tightening monetary policy, increasing its key rates by 250 basis points over the year. The impact on sovereign rates was very significant: the 10-year OAT rose to 3.0% at the end of Q4 2022 (vs. 0.19% at the end of 2021). This restrictive policy continued in 2023: the key interest rate reached 4% and was maintained at this level until June 2024.

Prime yields vs. ten-year OAT rates: 1992 - 2023

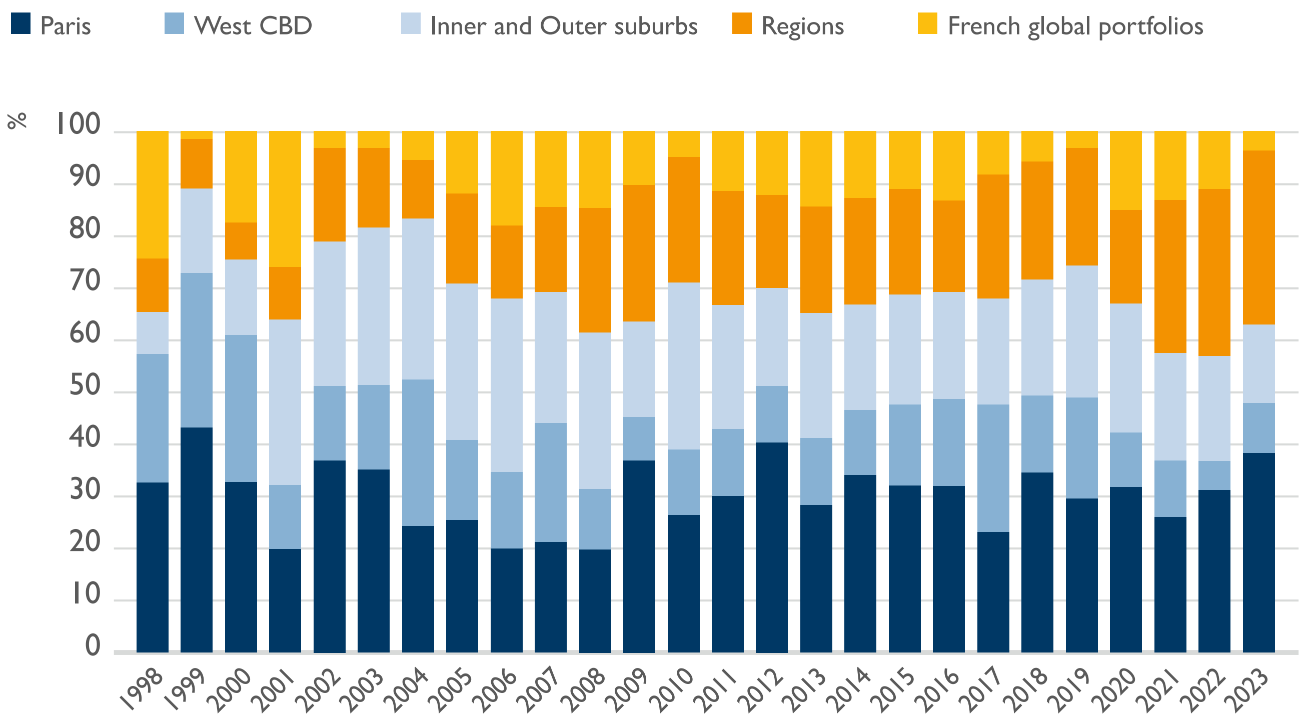


— Source : MBE Conseil

The investment market shrank significantly in 2023, with influx barely exceeding €12 billion. In addition to the excessively high cost of credit, which largely disadvantaged investment funds, **the sharp correction in appraisal values had a negative impact on a significant proportion of savings collectors, who were sometimes forced to lower the price of their shares and endured both a high degree of redemption requests and a sharp drop in their collects.** It is worth remembering, however, that as early as 2017, analysts anticipated a risk of market overheating, due largely to an overabundance of liquidity.

As in previous crisis, in addition to the more restricted financing available to investors, (which obviously reduces the number of large transactions), we are witnessing a persistent "wait-and-see" attitude among owners – many of whom can afford to retain their assets while waiting for values to rebound. **At the same time, largely due to the very high increase in the available supply of offices, investors have clearly been developing an aversion to this asset type. This includes a large proportion of new supply,** much of which was developed during the speculative project boom.

Investment volume by submarket: 1998 - 2023



— Source : MBE Conseil

As in every real estate crisis, obstacles will gradually diminish and, while it is likely that influx in 2024 will be very low, the attractiveness of certain asset types — particularly warehouses, retail assets, as well as offices in Paris and in attractive locations in regional markets — could enable market regrowth. For example, we are currently seeing foreign investors, particularly American investors, renewing their interest in large warehouse portfolios and hotels.

The slowdown in investment is also a consequence of a crisis in real estate valuations, particularly with regard to offices. In many instances, sellers' expectations remain too high compared to the means of most potential buyers. Commercial real estate as a whole is also currently suffering from a lack of attractiveness compared to other asset types, particularly stocks and bonds.

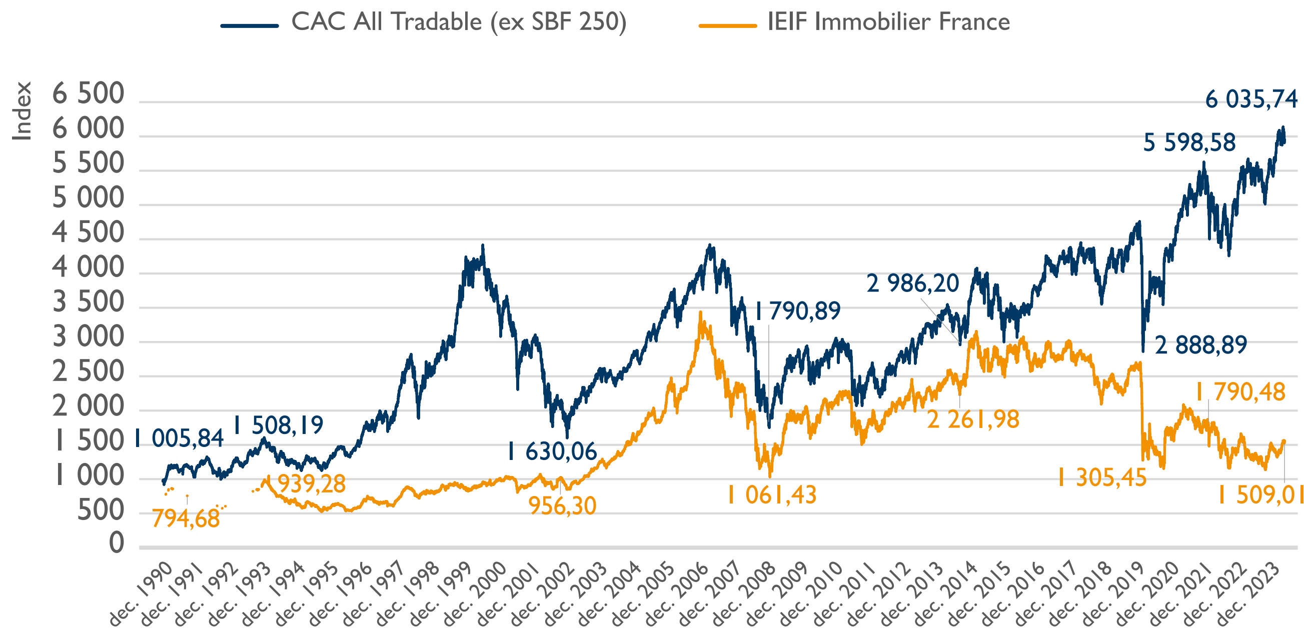
Since 2020, publicly listed real estate companies have underperformed to an unprecedented degree on French indices. The IEIF Immobilier France index, which monitors the performance of real estate companies listed on Euronext Paris, has verified the decline in the real estate sector compared to other listed entities in France.

From 2002 until the end of 2016, the performances of the IEIF Immobilier France index and the CAC All Tradable index (formerly the SBF 500) followed a similar trend. The average gap between the two indices was 980 points from 2002 to 2016, increasing to 1,510 points over the 2017-2019 period. This variation has now exceeded 4,100 points on average from 2023 to the present. **However, while the underperformance of listed real estate companies has been perceptible since 2016,** this should be qualified by appreciating that, between 2014 and 2020, the most active French real estate companies in the investment market were unlisted (ie., SCPIs and OPCIs).

Since 2020, the market discounts affecting the values of listed real estate shares have reached 40% on the IEIF index, whereas the drop in appraisal values observed in the assets of large institutional investors is between -5 and -10%.

Although the volatility on the stock markets has been greater than that seen for unlisted real estate, **it is highly likely that the ongoing market discount for the latter, (ie., the fall in asset values,) will continue.** Nevertheless, the drop in valuations is still too low to allow the commercial real estate sector to regain attractiveness among investors, thereby reviving the investment market.

IEIF Immobilier France vs. CAC All Tradable indices performance: 1990 – 2023 (excluding coupon payments)



— Source : IEIF

Major events and developments:

- Commercial real estate is presently enduring a multi-faceted crisis, originating from:
  - The Covid-19 crisis, beginning in early 2020, which brought transaction activity to a halt and contributed to the development of a "wait-and-see" attitude among both investors and tenants. This expanded into an economic crisis for many sectors including the technology sector (that previously boosted the rental market).
  - An energy and inflationary crisis, triggered by the war in Ukraine breaking out at the start of 2022. This has led to higher fossil fuel costs, impacting increased construction and operating costs, as well as rents in place through indexation.
  - A monetary crisis, with the end of quantitative easing by various central banks and the 400 basis point increase in key interest rates.
  - An office market crisis, with the increase in the vacancy rate and the delivery of an overabundance of new, unmarketed buildings, accentuated by a high rate of releases and lower space requirements resulting from the increased trend for remote working.
- Regulatory constraints linked to green energy transition policies (eg., ZAN, PLU Bioclimatique, tertiary decree) are increasing cost pressures on real estate assets.
- Comparisons across indices indicate sustained underperformance by listed real estate companies, perceptible from 2016 and worsening since 2020. The market discounts for underlying real estate assets (-40%) have far exceeded those for unlisted assets (-10 to -20%).

THE EXPERT VISION - **Catella Valuation**

- Real estate experts have an important role during market crises: to adjust valuations and to ascertain the impacts of macroeconomic trends on the value of buildings.

- Historically, in terms of real estate valuation, not all countries have reacted in the same way: sudden and significant variations in values in the UK, greater market inertia in France.

- Due to both the suddenness and the intensity of the rise in interest rates, the current crisis has caused a more rapid adjustment of valuations by real estate experts: an adjustment necessary for the market to rebound in order for sellers' expectations and buyers' financial means to reach better alignment.

Catella vision:

- By its nature, the real estate industry is subject to extended cycles. Its fundamentals are highly dependent on overall macro-economic and other conditions, such as GDP growth, demographic changes, transportation infrastructures, urban planning, governmental monetary policies, user behaviors, etc.

- **Our analysis of extended commercial real estate cycles makes it possible to determine certain well-established correlations:**
  1) On the take-up side, the sensitivity of transaction activity to changes in salaried employment levels;
  2) On the supply side, an absorption period of 5-7 years from its peak when markets are oversupplied[a];
  3) In periods of reduced supply, stock is renewed in less than two years after a negative take-up shock;
  4) A real scaling of the risk premium is necessary to ensure fluidity in the investment market, with a minimum of 150 to 200 basis points between the office prime yield and the risk-free rate[b];

- Real estate crises all have different fundamental characteristics, due to their triggers (ie, financial crisis, stock market downturns, health crisis, etc.), as well as pre-existing supply and demand balance.

- **The crisis we are presently experiencing in commercial real estate will have long-term repercussions, because it is simultaneously:**
  1) An office crisis (ie., supply shock, sluggish demand and changes in user behaviors).
  2) A crisis in real estate valuations (via the rise in interest rates).
  3) A financing crisis (ie., cost of debt and available equity for real estate).

- **Any feasible new path to growth will necessarily require adjustments, depending on the overall rental situation and the location of assets:**
  1) Adjustment of rental values: to make new buildings competitive and clear stock.
  2) Adjustment of appraisal values: to regain profitability, making commercial real estate more competitive compared to more liquid asset classes.
  3) The transformation of obsolete commercial property assets: to reduce the excess supply of underperforming or poorly located office buildings, and to partly respond to the current housing crisis: the other main element in the current real estate crisis.

(a) Half that duration in situations of limited supply, such as the environment following the subprime crisis.
(b) An OAT bond yield close to "zero" makes determining real estate risk premiums more problematic, and also contributes to artificially inflating the value of assets.

WITH CONTRIBUTIONS FROM

Amundi Immobilier

« The industry must continue to improve - particularly in terms of asset management - by placing the tenant at the centre of the equation. They must be considered a 'client' in their own right: one who requires real support, with anticipation of their needs in order to optimize their user experience. »

Hubert Joachim
Chief Invest Officer - Real Estate – Amundi Real Estate

CA ASSURANCES

« Since the Covid crisis, we have witnessed a polarization of the commercial real estate market. There has been a very good rental performance within Paris, but doubts about the future of the office market in certain other areas. »

Emmanuel Chabas
Head of Real Estate Investments – Crédit Agricole Assurances

Covea Immobilier

« We adapt our strategy according to market conditions, in order to provide the best returns for our clients. Our advantage: providing in fine yield grants us the ability to wait, given the size of our portfolio, and therefore to be less sensitive to IRRs than other investors. »

Charlotte Lacoste
Investment Director – Covéa Immobilier

DWS

« It is in times of crisis that we learn the most. The current crisis is leading us to greater selectivity and agility. »

Chiara Randazzo
Head of Transactions France & Belgium – DWS Group

ICADE

« The financial crisis, with the corresponding sudden rise in rates, has in turn generated new crises: production, cost prices and solvency. The financial equation then becomes more complicated, and invites us to rethink the fundamentals of the model. Our four strategic pillars are: the repositioning and diversification of our assets, the construction of the city of tomorrow, based on a mixed and sustainable use of spaces, and a rigorous financial policy. At the same time, a genuine evolution of the skills of our employees is underway, to adapt to the new market environment. »

Nicolas Joly
Managing Director – Icade

Union Investment

« Refocusing on 'core' properties in times of crisis allows us to get our hands, under favourable conditions, on assets that are more difficult to acquire when liquidity is abundant on the market. »

Diego Roux
Head of Transactions France – Union Investment Real Estate

CONTACTS

Isabelle Ramond
Associate Director
MBE Conseil
isabelle.ramond@mbeconseil.com
+33 (0)1 45 02 00 51

Raphaël Amouretti
CEO & Head of Capital Markets Île-de-France
Catella Property
raphael.amouretti@catella.fr
+33(0)6 74 74 56 23

Martin Monnet
Managing Director & Head of Capital Markets Regions
Catella Property
martin.monnet@catella.fr
+33(0)6 48 43 21 72

Grégoire Onillon
Managing Director & Head of Capital Markets Regions
Catella Property
gregoire.onillon@catella.fr
+33(0)6 33 47 95 74

Henri Guillaume
Deal leader Capital Markets Île-de-France
Catella Property
henri.guillaume@catella.fr
+33(0)6 71 95 24 46

Oceane Vinson
Head of Marketing, Communications & Strategy
Catella France
oceane.vinson@catella.fr
+33(0)6 31 07 85 39

CATELLA

Catella is a European finance group active in Corporate Finance, Investment Management and Principal Investments. 500+ employees work in 25 cities and 12 countries including France, Germany, the United Kingdom and Spain.

Catella Property combines the structured approach of an investment bank with local market knowledge and “dealability”.

Market study conducted by MBE Conseil for Catella Property

Catella Property
4 rue de Lasteyrie
75116 Paris
France
Tél.: +33 (0)1 56 79 79 79
info@catella.fr
www.catella.fr

This market analysis can be downloaded on www.marketsummarybycatella.com

Credits: Shutterstock