

## France Real Estate Strategic Outlook

### Third Quarter 2022

#### IN A NUTSHELL

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- Growing headwinds are challenging the French real estate market. Slowing economic growth and higher borrowing costs are expected to kickstart a period of real estate price correction.
  - Our investment focus remains on the living sectors. Affordable residential, student housing and senior living are all supported by solid market fundamentals and should prove resilient during economic disruption.
  - Logistics is not immune from a slowing economy, but supply-constrained urban logistics remains attractive. Given an appropriate price correction, we see opportunities for the redevelopment of secondary Parisian office stock.
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The first half of 2022 was shaped by significant changes to both the economic and geopolitical landscape of Europe. This period of high inflation is squeezing real household incomes and we have downgraded our economic growth forecasts as a result. Sharp increases and volatility in the fixed income market have had a notable impact on borrowing costs and as a result, like elsewhere in Europe, there is growing evidence of an ongoing price correction in the French real estate market. We anticipate outward yield movement across almost all sectors, and yields are now expected to peak much earlier in the cycle than we had previously predicted. Towards the back end of the ten-year forecast period, however, our outlook for property yields remains largely unchanged.

### Economic challenges weigh on French real estate

The short-term outlook for France is one of slowing economic growth. Inflation reached 6.1% in July, the highest level since 1985, albeit still among the lowest rates in Europe given stricter energy price caps and a lower reliance on Russian gas.<sup>1</sup> As household incomes are squeezed, cost-of-living pressures are evident through the sharp decline in consumer sentiment. It is worth noting that the risk of an inflation-induced recession is elevated. Over the longer term, the French economy is expected to grow broadly in line with the European average over the ten-year outlook, although Paris and other major French cities will likely outperform, supported by positive employment and population trends.<sup>2</sup>

The ECB has started a policy of monetary tightening, increasing interest rates in June for the first time in 11 years and ending an era of negative rates,<sup>3</sup> with further rate hikes expected over the coming months. As a result, French ten-year government bond yields rose to around 2.4% in June, and despite falling back to below 1.5% in August,<sup>4</sup> the spread between property yields and

<sup>1</sup> Oxford Economics, August 2022

<sup>2</sup> DWS, July 2022

<sup>3</sup> ECB, July 2022

<sup>4</sup> Macrobond, August 2022

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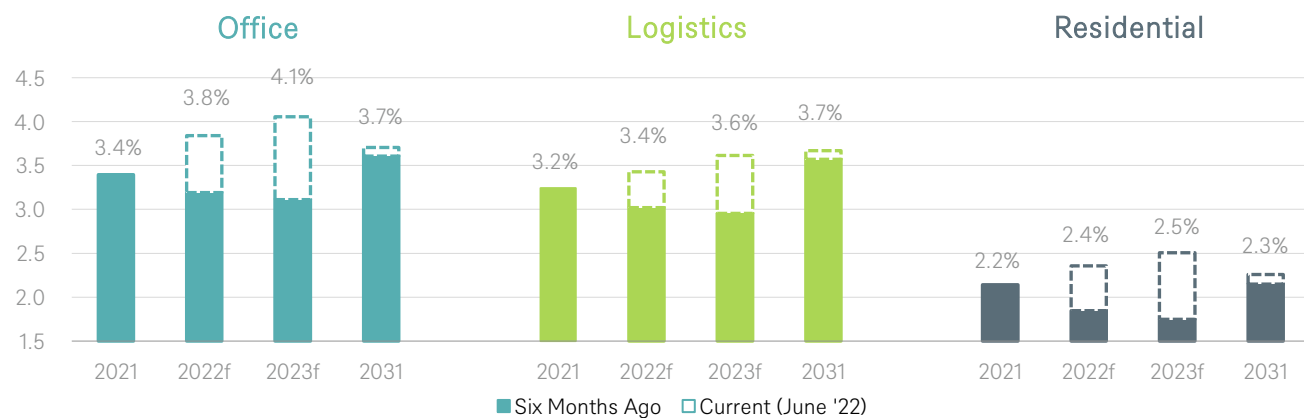
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the risk-free rate is markedly lower than at the start of the year. Alongside higher financing costs, these changes present immediate challenges to the French real estate market and we anticipate a period of price correction over the coming 18 months.

We expect prime yields to move out across most sectors, with the greatest correction in offices, where prime yields could move out by as much as 60 basis points in the Paris CBD and potentially even more in markets such as La Défense. Consequently, prime office values are anticipated to decline by as much as 15%, although secondary, low energy-rated properties could well see greater value declines. By comparison, prime residential yields in Paris are expected to increase by just 35 basis points over the coming 18 months, resulting in a price correction of less than 10%. While we expect a value correction in the short term, our long-term projections for property yields remain largely unchanged.<sup>5</sup>

### Prime Yields by Sector 2021-31f (current vs. six months ago, %)



Source: DWS, July 2022.

### Living sector well placed for outperformance

We continue to favour the affordable residential market, especially as we enter a period of economic uncertainty and high inflation, with undersupply and solid demand drivers underpinning increased resilience. The Greater Paris area is supported by positive demand fundamentals, including healthy population and employment growth. There may also be attractive opportunities in selected regional markets, such as Toulouse, which benefit from positive population growth and above-average income growth.

We also see the student housing sector as a resilient investment strategy. In previous economic downturns, the sector has shown anticyclical characteristics, with student numbers typically increasing in times when employment opportunities are weaker. Furthermore, limited supply of purpose-built stock relative to student numbers, particularly international students, bodes well for rental growth.

France's ageing population also supports senior living – particularly assisted living. Like student housing, the current supply of good-quality senior housing relative to the elderly population is limited. Currently there are only a limited number of up and built assisted living schemes available for investment, therefore the development of high-quality is likely to be the preferred route into the market.

<sup>5</sup> DWS, July 2022

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## Select value-add opportunities in Paris CBD

The recovery of the Central Paris office market continued over the first half of 2022, with take-up slightly exceeding the long-term average. Grade A office stock continues to account for the bulk of occupier demand, as office tenants prioritise best-in-class space with top ESG credentials. The supply picture in Paris remains varied, with submarkets such as La Défense and the Western Business District still struggling with relatively high vacancy, whereas the CBD has seen vacancy rates come down sharply in recent quarters to reach very low levels,<sup>6</sup> particularly for prime supply. Going forward, significant increases in construction costs are likely to dampen developer activity over the short-to-medium term, placing more pressure on supply in these submarkets and adding further impetus to rental growth as the economy recovers.

Overall, in a weaker economic environment, prime assets are expected to outperform the wider market, supported by lower void periods, stronger occupier demand and higher liquidity. However, a sufficient price correction for Paris CBD secondary offices could allow value-add opportunities in the refurbishment of well-located space. Indeed, the historic nature of much of the office stock in inner Paris offers an opportunity to upgrade dated assets to 'Next Generation' space, incorporating the latest technical and environmental standards, unlocking a potentially rental uplift. In our view, this value-add approach could lead to greater risk-adjusted returns over low-yielding new-build stock.

## Less drive behind corridor logistics rent growth

Much of the French logistics market is well placed to withstand economic disruptions, although there are markets that look more exposed to weaker fundamentals. With vacancy low across most markets, and demand still strong over the first half of the year, we do expect strong rental uplifts to continue in the short term. However, the logistics sector is not immune to wider economic disruption, and lower consumer spending, alongside slowing e-commerce growth, is expected to dampen demand. With that in mind, we anticipate that rental growth will be weaker next year, and will fall back in line with inflation over the longer term. Our outlook for Lille is arguably weaker than other French logistics markets, given a strong construction pipeline and fewer barriers to future supply.

On the other hand, urban logistics is expected to record continued strong rent growth over the forecast period, especially around Paris. The sector is supported by exceptionally tight supply and strong competition from other land uses. In addition, considering the notable growth in fuel costs, location selection for third-party logistics tenants will likely increase in importance and we expect that firms will look to locate closer to the end consumer in order to minimise transport costs, an important factor when considering our logistics strategy around urban and Last Hour logistics.

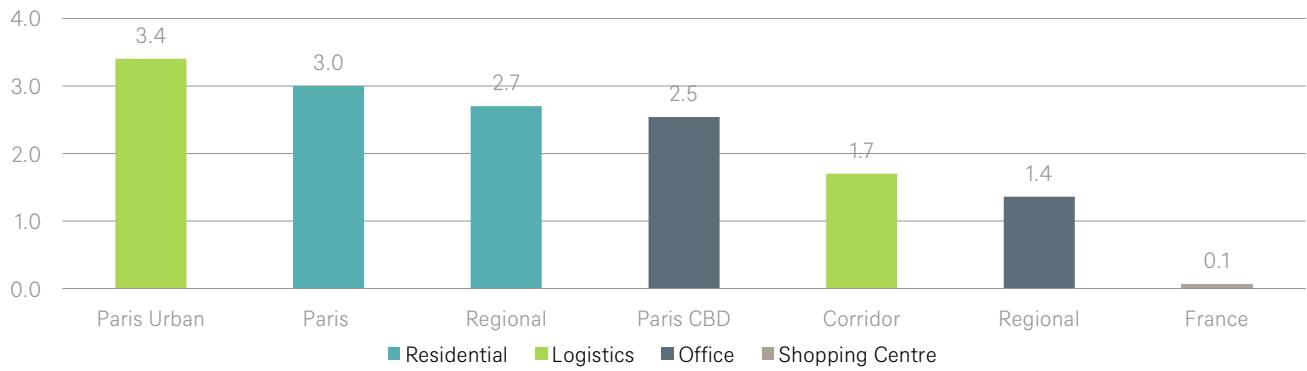
Like elsewhere in Europe, the French retail sector has suffered many setbacks in recent years, with the Covid-19 pandemic further exacerbating the sector's decline. In the short term, the sector's recovery will be hindered by waning consumer spending, alongside rising energy, labour and transport costs. As such, we expect further declines in shopping centre rents this year and next, with secondary shopping centres particularly at risk of both rental and capital value decline.<sup>7</sup>

<sup>6</sup> PMA, July 2022

<sup>7</sup> DWS, July 2022

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**Prime Rental Growth, 2022-31F (% p.a.)**



Source: DWS, July 2022. Note: F= forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

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