Alternatives Research
Real Estate

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DWS

FRANCE REAL ESTATE STRATEGIC OUTLOOK

First Quarter 2022

IN A NUTSHELL

- A slower economic recovery is now anticipated in the first quarter of 2022 due to the rapid spread of the Omicron variant, but growth is still expected to outpace the Eurozone average later in the year.
- Our investment focus has shifted towards the operational residential sector, including student housing and senior living, where demand is expected to grow rapidly.
- We see fewer opportunities for core investment in corridor logistics, given current pricing levels and an elevated risk of new supply, but urban logistics still looks attractive.
- Further rent and value declines are expected in the retail sector as more sales are diverted online.

Economic outperformance versus the Eurozone

This year is likely to bring further economic recovery for France, albeit at a slower pace than previously expected, with the short-term outlook clouded by the rapid spread of the new Omicron variant.[1] The French presidential election in April 2022 could present another source of economic uncertainty, although longer-term economic fundamentals are positive. Domestic consumer spending is likely to drive the recovery in 2022 and we expect the French economy to outperform the Eurozone over a ten-year horizon.

The Covid-19 pandemic has largely accelerated existing trends in the real estate market. Logistics has attracted record levels of occupier demand, while shopping centre vacancy increased for the tenth consecutive year.[2] Demand for offices remained weak until the second half of 2021 and we expect that a structural shift towards remote working for a proportion of the week could permanently dampen demand for office space outside the best locations.

Focus on office refurbishment to Next Generation

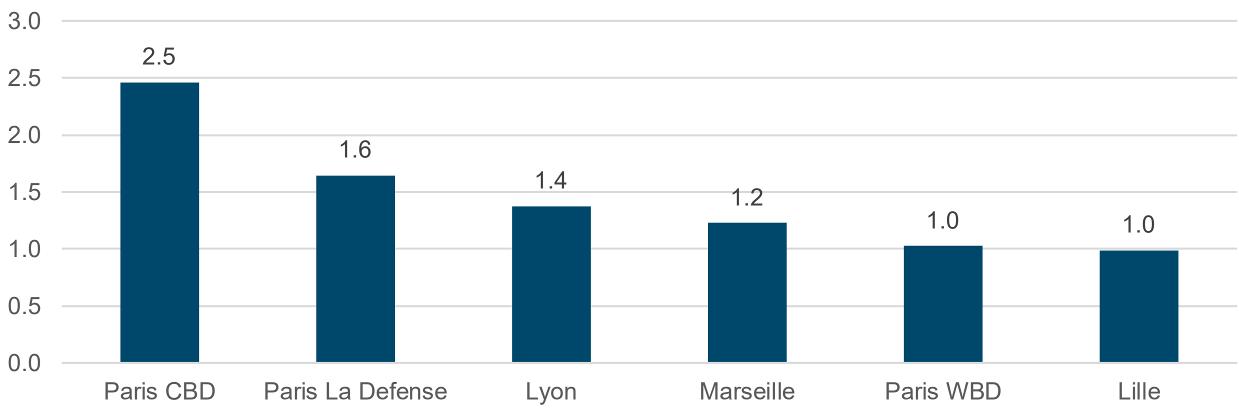
After an extended period of weak office demand, strong signs of a recovery in Central Paris were noticeable during the second half of 2021, although some submarkets are performing better than others. Take-up in the CBD was down by only 2% year-on-year, and demand in other central submarkets (including the 3rd to 11th arrondissements) was above pre-pandemic levels. Take-up in La Défense, however, has been slow to pick up and other less central submarkets are also taking longer to recover.

[1] Google Mobility Data, December 2021
[2] DWS, December 2021

This supports our call to focus on refurbishment strategies in inner and emerging Paris. Supply growth tends to be constrained in inner locations: net completions in the CBD have averaged just 0.2% of stock per annum over the past 10 years. Demand also tends to be more resilient, and with the rise in remote working, we expect that occupiers will continue to opt for less high-quality space in the best locations rather than increasing their office footprint in cheaper submarkets. The historic nature of much of the office stock in inner Paris offers an opportunity to upgrade dated office stock to the latest technical and environmental standards and unlock a strong rental uplift.

The regional office markets offer limited opportunity to execute this strategy, except in the most desirable locations, as rental levels are lower and we see less upside potential given weaker forecasts for economic growth. Lille, for example, has seen almost no rental growth for the past 10 years. Euroméditerranée in Marseille still looks attractive given the more constrained availability, but the wider Marseille market is unlikely to outperform the European average given the reliance on the public sector to drive demand. Lyon is expected to outperform other regional markets based on stronger economic growth; however, risks remain around new supply.

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



Source: DWS, December 2021.
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.

Logistics increasingly fully priced

After a period of exceptionally strong yield compression for logistics, we now expect capital value growth to moderate over the next five-to-ten years. While take-up over 2021 represented a 22% year-on-year increase,[3] strong demand has so far failed to translate into significant rental growth.

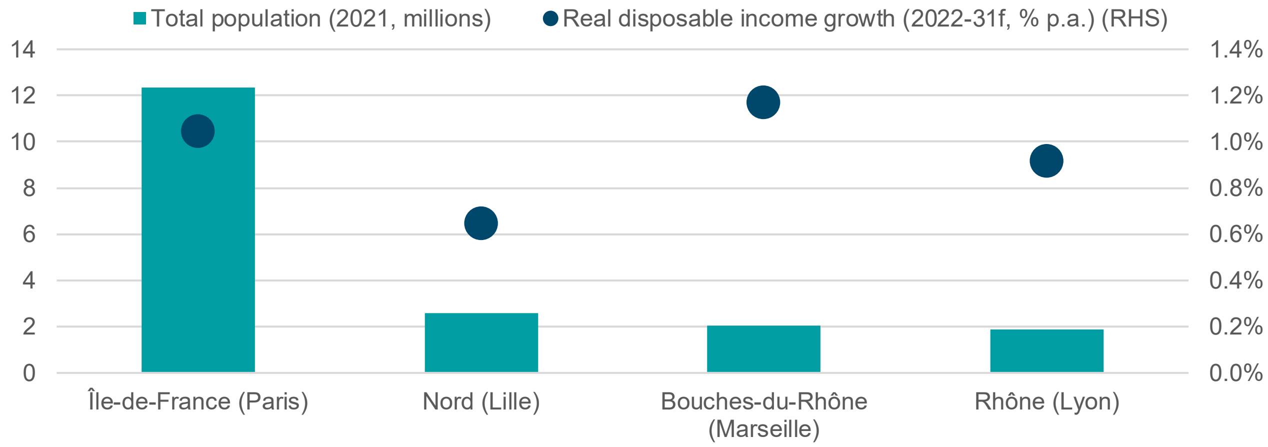
A surge in speculative development is likely to constrain rental growth in the wider Lille market over the next five years, although we expect better performance in Paris and Lyon, where availability of land is more limited. But overall, we expect the logistics sector in France to underperform relative to the European average for logistics until 2026. Given the current strong investor appetite for logistics assets, we recommend a pivot in strategy towards selective sales of existing ageing assets in weak corridor locations.

Urban logistics continues to be an outperformer. We retain a focus on this subsector as high demand from occupiers looking to deliver straight to consumers, as well as the supply protection generated by limited land availability, should offer continued support to the outlook for rents. Investable urban stock remains limited, but we see the greatest

[3] CBRE, Q3 2021

opportunity to execute this strategy in Paris and Lyon, which combine a significant urban population with strong rates of household income growth, driving demand for consumer goods.

Population and household income growth



Source: Oxford Economics, January 2022

We also advocate reducing exposure to the retail sector. This may be through conversion or sale where there is liquidity. Shopping centre rents are expected to continue to fall as e-commerce gains market share over the next five years. Secondary shopping centres are particularly at risk of both rental and capital value decline. Even though average prime shopping centre values have already fallen by more than a third since the peak in 2016,[4] we are still forecasting further falls over the next two-to-three years. Even holding a prime shopping centre for another ten years may only result in values recovering to today's level and may come with significant risk on the occupier side.

Operational beds sectors growing in importance

We continue to explore opportunities in the residential market where strong growth in population and household income is driving rental growth. Greater Paris remains our top focus for the private rented sector, given the outlook for above-average disposable income growth and potential for additional rental growth in suburban locations with the phased opening of the Grand Paris Express over the next ten years. There may also be attractive opportunities in select regional markets, such as Toulouse, which benefit from positive population growth and fast-growing incomes.

We also see student housing as a key investment focus. Limited supply of purpose-built stock relative to student numbers, particularly international students, bodes well for rental growth. Additionally, there might be scope for yield compression in this sector as student housing commands an attractive yield premium relative to residential, compared to mature markets such as the United Kingdom.

France's ageing population also supports the senior living investment story. Like student housing, the current supply of good-quality senior housing establishments relative to the elderly population is limited. We see an opportunity in forward-funding high-quality senior living assets.

[4] Cushman & Wakefield, DWS, December 2021

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