

# FRANCE REAL ESTATE STRATEGIC OUTLOOK

Mid-Year 2021

## IN A NUTSHELL

- \_ A return to economic growth should support a recovery in office rental growth, but long-term prospects for demand remain uncertain, particularly for commodity office stock and secondary locations.
- \_ Urban logistics is likely to be among the best-performing parts of the market. However, some regional logistics markets are starting to look fully priced.
- \_ Pricing is tight for Paris residential, but the market may hold some opportunities in more attractively priced commuter locations.

The French office market is emerging from a period of very weak demand, leaving a legacy of elevated vacancy. Despite the improving economic picture, it will take time for rental growth to recover while availability gradually declines. The logistics and residential sectors are our top areas of focus, having weathered the pandemic well and with strong demand fundamentals likely to support attractive rental growth projections and yield compression. The restrictions imposed upon retail stores over the past year have added additional pressure to an already beleaguered sector, and here we expect rental decline to accelerate before levelling out in around three years.

## Economic conditions improving

France is currently enjoying a consumer-led economic rebound. Over the next five years, we expect the French economy to outperform the Eurozone, with GDP in the Ile-de-France region growing by an additional 20 basis points per annum above the national average. Depending on the outcome of next year's election, there are potential upsides for economic growth should structural reforms to improve French competitiveness be achieved, such as lower corporate taxes, reduced bureaucracy, and a higher labour participation rate.

## Active management to become more attractive in office market

The office market in Central Paris had a particularly weak year in terms of demand in 2020, resulting in vacancy more than doubling in the CBD. This change in the occupier balance has reversed the recent upward pressure on rental growth and we expect some rental decline this year. In the longer term, we have a neutral call on the CBD as availability is likely to decline as occupier demand picks up, and the pipeline of new stock is still very limited.

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The market has a low proportion of recently built stock and as occupiers require increasingly high-quality space, there is an opportunity to realise outperformance in refurbishing well-located assets in the CBD to the latest standards and realise rental upside.

In La Défense, weak demand has coincided with a strong supply surge and we expect to see a sharp drop in prime headline rents this year, with negative growth spilling into 2022. Improving transport connections due to an extension of RER line E in 2022 and the arrival of the Grand Paris Express over the next 10 years could improve the market's draw for occupiers, and there may be an opportunity to acquire assets at an attractive yield in 2022 and capture the upside from a turnaround in rents. However, there are risks to this outlook. The supply pipeline is still likely to be strong in 2024 and 2025 and there may be a longer-term reduction in office demand should the working-from-home trend outlast the pandemic.

Regional office markets offer a mixed picture. Occupier demand is strong in Lyon but a substantial pipeline is likely to take the pressure off rental growth in the next five years. Net completions are also high in Lille but weaker regional economic growth is likely to reduce demand for office space and we expect rents to increase by less than 1% per annum over the next five years. Marseille's Euroméditerranée area offers some opportunity for refurbishment as vacancy is low, particularly for modern stock, but rental growth is likely to be relatively limited.

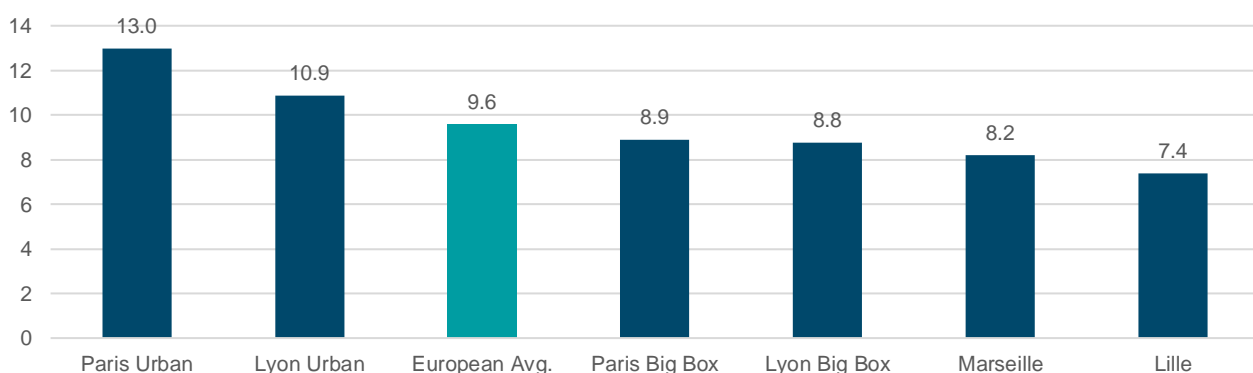
Overall, we do not have a primary focus on the office market in France, given the uncertainty over how well occupier demand will pick up following the pandemic, as well as limited prospects for further yield compression.

## Narrowing opportunity in logistics

Over the past 12 months, prime logistics yields in France have compressed by around 50 basis points and now stand at close to 3.50%, among the lowest in Europe.<sup>1</sup> While there is still some room for further yield compression, regional France is falling down the list of preferred logistics markets as supply growth is likely to constrain future rental growth and there is currently very little yield premium on offer over Paris.

However, urban logistics in Paris is one of our top-performing markets across all sectors over the next ten years. The fundamentals are very positive for logistics demand, with a large and affluent population to serve and an online sales ratio that has risen sharply since the onset of the pandemic. Over the next five years, French e-commerce sales are forecast to grow at double-digit rates, giving a strong impetus for logistics demand close to the city.<sup>2</sup> Locations such as Brétigny-sur-Orge to the south of Paris, or Gennevilliers in the north are highly supply constrained, which should support strong rental growth.

### LOGISTICS PRIME TOTAL RETURN (2021-25F, % P.A.)



Source: DWS, July 2021. F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

<sup>1</sup> CBRE, PMA, 2021 Q2

<sup>2</sup> Business Wire, December 2020

The growth and popularity of logistics has come at the expense of the retail sector, which is undergoing a period of significant price correction. Shopping centre rents were already trending downwards before last year, but the shift in spending patterns brought on by the pandemic means we now anticipate a sharper near-term fall, and don't expect rents to return to pre-pandemic levels for at least 10 years. In addition to an increasing proportion of sales moving online, the prime high street market has suffered from a lack of tourist footfall over the past 18 months, with rental values falling by almost 24% year-on-year by Q1 2021.<sup>3</sup>

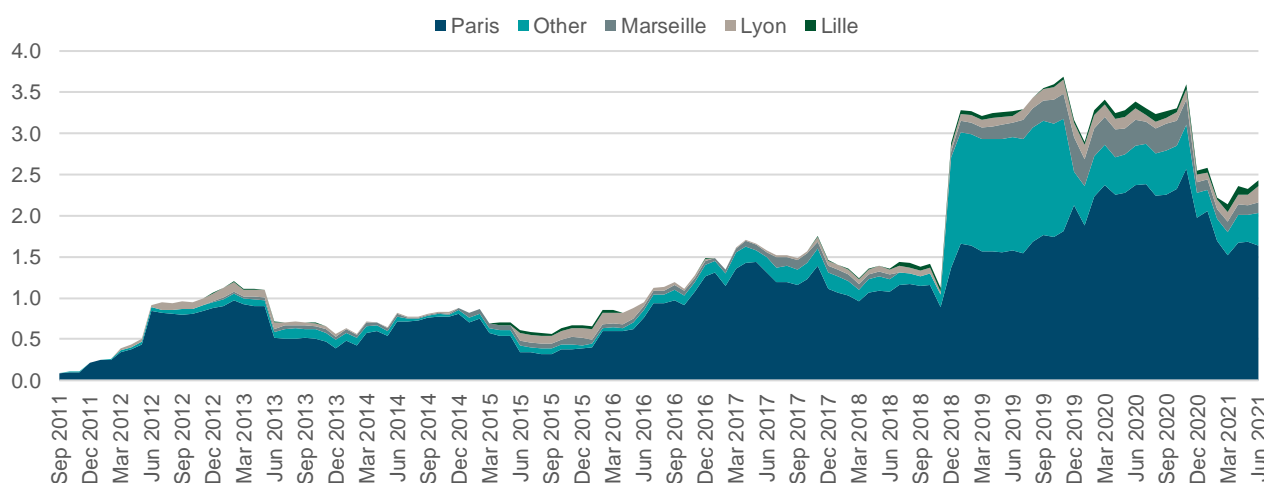
## Paris residential an increasing focus

Residential investment in France is growing from a low base. In a nod to the current popularity of the sector, volumes in the 12 months to mid-2021 comprised 15% of the all property total, compared with just 5% on average over the past ten years.<sup>4</sup>

We see a slight outperformance in Paris, which is the most liquid market, and the most promising for the private rented sector. This is due to having a significant and growing population of young professionals with a higher propensity to rent, particularly given the rising price of buying a property. Supply is highly constrained, but development is picking up in well-connected suburbs which are likely to benefit from connection to the Grand Paris Express. We see the greatest opportunity in these areas, which also trade at more attractive valuations compared to the city centre, although entry yields are still relatively low.

The key risk in this market is regulation, which is highly protective for tenants, with the Loi Elan already preventing rents from rising beyond a given threshold each year. Nonetheless, with experience, expertise and on the ground asset management, this should not be seen as a major barrier to investing in the French residential sector.

### FRANCE RESIDENTIAL SALES VOLUME (€BN)



Source: RCA, July 2021.

<sup>3</sup> CBRE, Q1 2021

<sup>4</sup> RCA, July 2021

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