PARISIAN Real Estate Advisor

PARISIAN REAL ESTATE ADVISOR'S QUARTERLY LETTER

2016 #10

April
May
June

Just like every quarter, we are pleased to share our convictions on the French real estate market with you. We are at your disposal to discuss these views further and wish you a pleasant read!

Jean Ph. BESSE
Chairman & Founder

French Real Estate market overview

2015 was particularly dynamic in terms of investment volume in France. We had mentioned that it was the second best year we saw just after 2007 but in fact it is even better than that: the final figures are above expectations with a global amount of **€31.3bn** invested in 2015 vs **€30.9bn** registered in 2007 (source: BNP Paribas Real Estate). 2016 definitely started slower as global volume decreased by 35% compared to Q1 2015, and by 50% in Paris region (source Immostat). However, it won't be a lasting trend and investment should accelerate by the end of Q2 2016 some significant transactions are currently being completed and that will have a significant impact on the figures. To illustrate, the deal for the "First Tower" in La Défense Business District will be closed in the coming weeks for an amount of **€800M**. There is no doubt that the real estate asset class remains extremely attractive, and just as in 2015, French investors are still in the majority, representing 73% of the investing volume in Q1 2016 (64% in Q1 2015).

No big change on the rate and yield side either: French 10-year bond is under 0.5% and is expected to decrease again. Given the abundance of liquidity, initial yields for real estate are following the trend and are still on a declining path on all prime markets and segments of activity. In Paris CBD, initial yields should be under 3% in the coming months. Prime retail buildings are already at 2.75% (source: BNP Paribas Real Estate).

This situation was not a matter of concern until now since the spread between risk free rate and initial yield remains extremely favorable to the real estate asset class, representing a major difference with the pre-crisis situation of 2007 when bond return was above real estate return. But despite this favorable spread, first concerns have arisen: in a publication dated April 2016, the French organization in charge of watching financial market stability (Haut Conseil de Stabilité Financière - HCSF) warned against a possible significant overvaluation of the commercial real estate market especially in Paris. According to the HCSF, rental incomes are on a decreasing trend since the end of the 2000's and the slight increase over the last months is not significant enough to balance current rents incentive that represent 6% to 30% of the annual rental income (15% on average in Paris region).

To explain this incredible rise in commercial real estate prices, the HCSF have brought forward several arguments. Some of them being perfectly rational such as the favorable spread as stated above, or the acceptance by investors of a lower return but with a very limited risk profile. Another element has to be taken into consideration according to the HCSF: investors' inertia. They are actually used to considering real estate investment as historically profitable. That is why the downward trend in profitability has not yet been taken into account in their investment strategy.

But why this inertia? Should we consider that it is inherent to institutional investors or find justification in the lack of a qualitative alternative to prime real estate investment?

Which alternative?

Prime yields are historically low but in the context of uncertainty and sluggish growth in France, investors are not ready to increase their risk and continue to focus on prime assets. That is why we wish to explore a new approach and offer an innovative alternative for commercial real estate investment and ensure an optimal risk/return ratio to investors.

As previously mentioned, Paris and major regional cities in France have been hit by strong yield compression: Lyon is now under 5%, Aix/Marseille, Lille, Bordeaux and Toulouse under 6% at the end of Q1 2016 according to BNP Paribas Real Estate. But secondary markets are still spared. Obviously they suffered from their lack of depth but we are convinced that with extremely qualitative tenants, that could be compensated. France is well known for its extreme centralization around Paris, but some public or quasi-public bodies have to be present throughout the whole territory, for example energy provider or local administrations.

We choose to focus on these types of tenants offering many advantages for real estate investors: first of all, they are extremely resilient in the case of economic turbulence. EDF, public French provider of electricity is the best example to illustrate this: despite strong internal troubles and a violent decrease in stock price, the French Government brings its full support to the group. Default is not an option. Secondly, these types of tenants generally have a long-term real estate policy defined by a corporate real estate department. As an asset manager, we work closely with them to ensure the investor gets a long lease, which is a key element in these secondary markets where vacancy is the major risk.

Last but not least, we mentioned above investor's inertia as an explanation of price's rise. Inertia of public companies is also well known and clearly leaving a building is a move too significant to initiate quickly: once again, we are confident as we have long-term visibility with these tenants.

Going further with this strategy it is striking to note that in the current environment, public bodies are clearly looking for more liquidity. A "sale and lease-back" strategy is for them one of the most efficient ways to recover cash flow. For this reason, numerous investment opportunities should be brought on the market in the coming months.

To conclude, this strategy of combining secondary markets with public tenants is the best alternative to prime markets. Actually, if these are still offering market depth, the level of initial yields combined with a potential overvaluation doesn't lead to an optimal risk/return ratio. On the contrary, a long lease with a public tenant in a secondary market offers a yield of around 7%-8% with limited risks considering all the arguments developed above. And as usual, Parisian Real Estate Advisor is at your disposal to study this innovative strategy further with you and to propose to you investment opportunities that match your criteria!

Quarterly letter #10 – Q2 2016 – Sources: Parisian Real Estate Advisor, BNP Paribas Real Estate, JLL, Haut Conseil de Stabilité Financière. - www.parisian-advisor.com
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