PROPERTY & OUTLOOK

QUARTERLY NEWSLETTER OF LA FRANÇAISE

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Real Estate Update and Outlook

The financial markets have rarely followed the French elections as closely as they have over the last few weeks. There was a significant reaction by interest rate markets in response to the difficulties faced by former favourite Mr Fillon as well as the risk of Mrs Le Pen being elected. The spread between French and German long rates widened considerably to over 80 basis points before returning to 64 basis points at the end of February. These were however the only markets to genuinely take on board these 'risks' as only marginal reactions were seen in the stock and exchange markets.

Given this context, the most surprising shift has undoubtedly been seen in short-term German rates which posted sharp falls throughout the month reaching a low point. These rates are difficult to explain in macro-economic terms as European growth is gaining pace and inflation has surprisingly increased in the Eurozone.

The stress caused by the French elections is undoubtedly responsible for an element of the changes seen in German rates. This disconnect between economic fundamentals on the one hand and the level of rates on the other is likely to continue while the ECB is unwilling to adopt a less accommodating posture. If this virtuous trajectory of macroeconomic figures is to continue, it should be seen over the course of 2017 and result in a gradual increase in German rates.

Investments in real estate markets have remained very high, further accentuating downward pressure on yields. Volumes therefore reached record levels in Q4 2016 at €87 billion, bolstered by the traditional end-of-year rush which was particularly strong in France and Germany. The London market also posted good results for Q4, despite several months of sharp falls in investments which have caused the annual European volume to plummet. €251 billion was invested in 2016, a 10% decrease compared with 2015. Volumes fell by 37% in the United Kingdom as uncertainty surrounding Brexit has led investors to postpone decisions. The prime yield in London therefore started to rise from Q3. However, investments gained pace in more secondary countries where there is a greater availability of quality assets for sale. The average prime yield for offices in continental Europe posted a further contraction. Levels reached 4.12% by the end of 2016 compared with 4.22% over Q3 and 4.36% at the end of 2015. German markets in particular posted sharp yield contractions and levels now stand at 4% or lower. The average prime yield is likely to see further contraction in 2017. This additional compression will lead to a reduction in the risk premium, although levels will remain considerably higher than the historical average.

People are croaking about it

This co-working space isn't bad at all. | Yesss! | Don't you mean co-yawning ? | Yes, let's co-yawn! Crooaaak!

DECODING THE COMMERCIAL
REAL ESTATE ENVIRONMENT IN FRANCE

The French commercial real estate market: more activity in the rental market, but no increase in rents

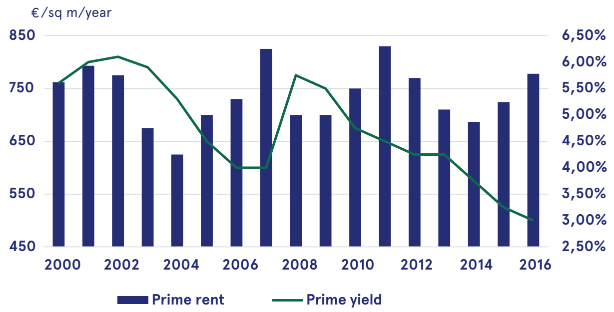
French economic growth posted a 0.4% increase over Q4 2016 and reached 1.1% for the year as a whole, representing a -0.1% decreased compared with 2015. Apart from the United Kingdom's withdrawal from the European Union and the series of terrorist attacks that have affected tourism, household consumption stagnated over Q2 and Q3 and this is now calling into question the growth forecasts that were announced at the beginning of the year. As a result, Rexecode has lowered its GDP grow forecasts from 1.6% in January to 1.1%. However, activity proved to be more robust over Q4 2016, driven by an upturn in industrial output (+2.2% in November) and household consumption. Falls in unemployment, seen since the summer, should continue in 2017. Rexecode has announced more stable growth of 1.1% for this year and there has been considerable improvement in the unemployment rate which now stands at 9.4% - all within a climate of uncertainty linked to the effects of Brexit and the French presidential elections. In addition, Insee is forecasting an inflationary rise of 0.8% for 2017, a moderate level but one that will still erode French purchasing power and, in turn, slow consumption.

Activity in the Paris rental market was stronger activity in 2016 with an annual transaction volume of 2.4 million sq m, representing a 7% increase compared with 2015. Almost half of demand was located in Paris and was driven by strong activity from companies in the new technology sector. Supply fell once again this quarter and now stands at 3.4 million sq m with a vacancy rate of 6.2%. Levels have fallen by 10% over the last 12 months, but with some significant geographic variation. Rates therefore remain higher than the long-term average across all areas apart from Inner Paris where the vacancy rate stands at 3.5%. New supply fell further and now only accounts for 15% of overall availability. Changes in rents reflect this position. Prime rents may have stabilised in the capital over Q4 2016 after seeing increases since the beginning of the year, but trends vary depending on the area and prime rents in the Outer Suburbs continued to fall. The decreases for second-hand assets were more substantial. In addition, incentives remain high but levels should slowly reduce over 2017. Rental incomes could therefore gradually stabilise for second-hand assets.

In France, investments stood at slightly more than €25 bn in 2016, a level which remains high and stable compared with 2015. H2 2016 saw strong activity from international investors who, given the uncertainty arising from Brexit, are redirecting their capital away from the United Kingdom to France and, more specifically, the Paris region. As usual, the Greater Paris Region accounted for two-thirds of investments and there were four transactions for lot sizes of over €500 compared with two in 2015. The Paris Central Business District even posted a record level with €5 bn in investments. The prime office yield saw further contraction over Q4 2016. This decrease, combined with the rise in interest rates at the beginning of November, has led to a reduction in the risk premium. This stood at 231 points at the end of the year, which remains a comfortable level compared with the average of 141 basis points seen over the last 20 years.

The contraction seen in prime yields continued into Q4 2016 for both office and retail assets. The prime yield for those assets most sought after by investors retail now stands at 2.85%, representing a 15 bps compression over the year. The prime office yield stood at 3% at the end of 2016 (-25 bps); this is a low level but it still allows for an attractive risk premium of 231 bps. Yield compression should continue in 2017 (unless there is an unexpected political outcome) as investor appetite for real estate remains strong while core supply is increasingly scarce.

Prime rent and yield



Source: CBRE - LF GREIM Research, February 2017

DECODING THE COMMERCIAL REAL ESTATE ENVIRONMENT IN THE UK

The UK real estate market: prime market values falling

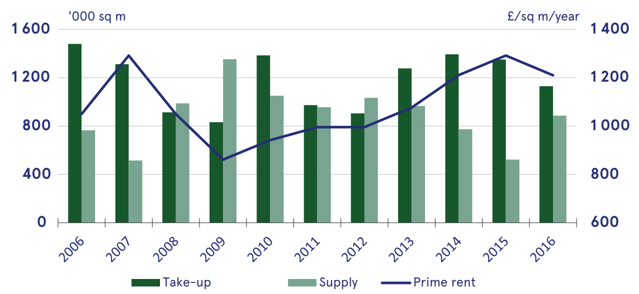
UK economic growth remained strong over Q4 2016. GDP increased by 0.6% over the last quarter and by 2% over 2016 as a whole. The depreciation of sterling has attracted a higher number of tourists which has driven consumption. However, job creations have slowed.

Despite this sustained economic growth, the London rental market has shown some signs of a slowdown since the referendum outcome in favour of Brexit. Following a slight increase in yields recorded over Q3, prime rents in the West End fell towards the end of the year. This was mainly due to a rapid rise in the vacancy rate as, given the uncertainty linked to Brexit, take-up remained satisfactory. Levels even held over Q4 with 346,000 sq m of take-up driven by some major transactions carried out by public authorities and service companies in particular. The decrease over the year as a whole was contained with 1.3 million sq m of take-up, representing a 17% decrease compared with 2015. With a more sustained level of completions, there has been a considerable increase in the vacancy rate which rose from 3.5% to 4.2% over Q4. The prime rent therefore posted a 6% decrease over Q4. Future supply should rise considerably over 2017 with levels weighing on rental values: even if half of this space is pre-let, a high volume of second-hand space will be released.

There has been a marked decrease in investments. Despite an active last quarter in London, €60 billion was invested in 2016, representing a 37% decrease compared with 2015. In sterling terms, the volume remains close to that recorded in 2015. Despite the prudence of British institutional investors, foreign investor appetite remains strong as these players seek to benefit from the depreciation of sterling. The London prime yield remained stable over Q4 at 3.75%. Prime market values for office space also fell over 2016 due to a combination of rising yields over Q3 and falling rents over Q4. These decreases reached 13% in sterling terms and 26% in euro leading to a marked increase in foreign investor purchasing power.

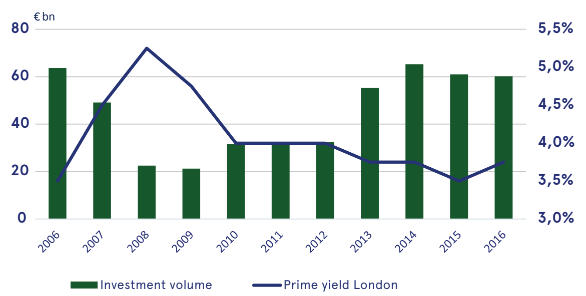
The negative effects of Brexit on the UK economy should start to be seen over the course of 2017 and the UK real estate market already appears to have started the process of correction. These adjustments should continue, mainly through rising yields as investors increasingly postpone decisions. Over the next few quarters, levels could fall by 50 basis points. In parallel, rents should continue to fall in most London market areas. These decreases should be sharper in the City where a higher level of completions is expected and specialised employment in finance is slowing. In addition, new technology companies also appear to be less inclined to expand. Take-up will therefore see further decreases in 2017 while the vacancy rate will continue to rise. Market values are expected to decrease over 2017 and 2018 and these lower prices will allow investors to reposition themselves in the market over the medium term.

Central London take -up, supply and prime rent



Source: CBRE - LF GREIM Research, February 2017

Investment and prime yield



Source: CBRE - LF GREIM Research, February 2017

DECODING THE COMMERCIAL REAL ESTATE ENVIRONMENT IN GERMANY

The German commercial real estate market: market values rising

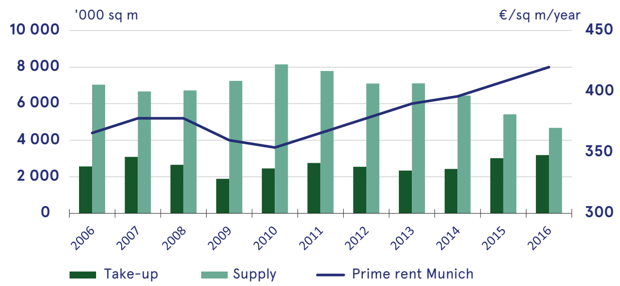
With 1.9% growth recorded in 2016, the German economy is in fine health. Consumption remained strong and was bolstered by one of the highest employment rates in Europe.

Occupier demand remained particularly strong in 2016. Over 3.2 million sq m was transacted in the five main markets, representing an increase of almost 6%. There was a good level of major transactions which included 25 leases for spaces over 10,000 sq m. Take-up was driven by demand from new technology companies. These accounted for 22% of transactions and even 34% in Berlin. The German capital posted a marked increase in net absorption, meaning that the amount of office space leased was much higher than the amount of space released. This means that companies are relocating to larger premises. Supply fell once again: 4.6 million sq m is currently vacant across the five largest markets compared with 8.2 million sq m at the end of 2012. At the end of 2016, the vacancy rate stood at 5.8%, its lowest level since 2002. There has been an upturn in future deliveries which are up by 38% compared with 2015, although the pre-let rate is very high at close to 70%. Prime rents increased significantly in 2016. In Berlin, rents surged by 17% year on year to €330 per sq m/year.

The investment market ended 2016 with a similar volume to that seen in 2015 with almost €54 billion in investments. The lack of quality product available for sale, particularly in the major cities, has stifled strong investor appetite for German markets. This has led to investors shifting their attention to diversification products with lower values per sq m. All markets posted a decrease, some substantial, in prime yields which now stand at or below 4% and even 3.2% in Munich. Yield compression has been particularly marked for less core assets due to the rise in investments with a higher risk profile with the expectation of future rental increases. Increases in market values were therefore lower than in 2016. These were mainly based on yield compression but have also been able to benefit from rising rents. There was a slight decrease in the risk premium over Q4, this was due to combination of the Bund returning to slightly positive since October and falling real estate yields (scissor effect). However, the level remains very high at 301 basis points compared with 156 basis points seen since the end of 1997.

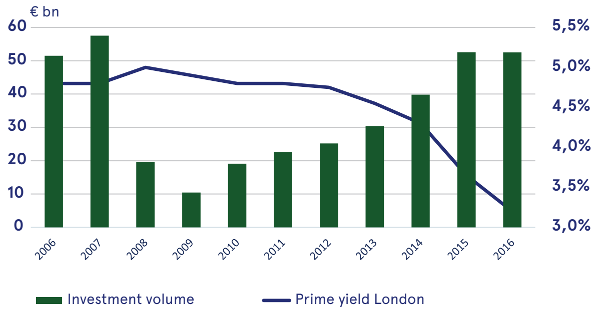
Despite the strong economic outlook, growth is set to fall in 2017. Levels should therefore reach 1.5% as trade with the United Kingdom is hampered by the gradual start of Brexit negotiations. In addition, the return of more sustained levels of inflation could slow consumption. However, the unemployment rate should fall further and stabilise at 6%. Job creations are therefore set to continue. Take-up could therefore stay at a high level and the vacancy rate continue to fall. Prime rents for quality assets located in the best locations, particularly in Berlin and Munich, should therefore continue to rise at a sustained rate. Prime yields could see further contraction, although at a slower rate than in recent years.

Take - up, supply and prime rent



Source: CBRE - LF GREIM Research, February 2017

Investment and prime yield



Source: CBRE - LF GREIM Research, February 2017

DECODING THE RESIDENTIAL REAL ESTATE ENVIRONMENT IN FRANCE

The French housing market: sharp increase in activity over 2016

The marked upturn seen in the new homes markets gained pace in 2016, both for new homes from developers and individual houses with no developer. As such 109,000 developer sales were recorded throughout the year representing a 6% increase compared with 2015.

Following a period of continual decline since 2012, there has been an increase in construction starts for new homes. These amounted to 376,500 units in 2016, an increase of 10% compared with 2015. The number of construction starts fell slightly over the last quarter but levels should strengthen over 2017. In fact, the number of building permits granted increased in 2016 rising by 14% to 453,200 units.

There were widespread increases for new homes across France (+2,5%). These gained pace towards the end of the year and rose by 3.6% over Q4 alone.

The rental market saw a continuation of the upturn which was first seen at the beginning of 2016. Normally buoyant between June and September and then slower from October, the market gained pace towards the end of the year. After having posted a 1.1% decrease in 2015, rents rose by an average of 0.5% year on year in December. Levels have continued to rise since the beginning of the year, although at a slower rate (0.3%). However, there were some marked variations as some cities, including the largest (Lille and Marseille) saw rents stagnate or even fall.

On a national level though, the market remains under pressure from strong demand. This increase in rents, albeit slight, has stifled the spectacular increase in residential mobility which had reached a historical high of 33% in November when it was 5 points higher than the average for the last 18 years. This has since fallen and stood at 29.8% at the end of February, particularly in the Greater Paris Region where it is normally far lower than the national average.

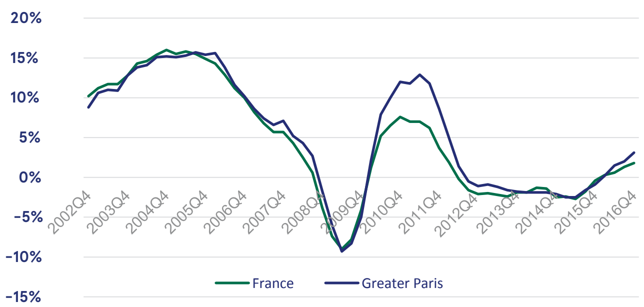
Efforts to upkeep and maintain housing have seen further considerable decreases since rents increased. As a result, only 14.5% of re-let accommodation benefited from major renovation works in 2017. This level remains well below the average which stands at 22.2% since 1998.

The good activity seen in the established homes since the end of 2015 continued and has reached record levels. Transactions have in fact exceeded the very high levels seen in 2006 with 848,000 transactions recorded in 2016. This strong increase is mainly due to very low lending rates for real estate (1.34% over 15 years in December) and to economic recovery, albeit timid, which has led to job creations which are synonymous with intranational geographic mobility.

Price rises for established homes gained pace after having fallen consistently between 2012 and 2015. In 2016 prices for established homes posted year-on-year increase of 1.8% in France and 3.1% in the Greater Paris Region. Apart from improved real estate purchasing power due to consistently low rates, there is also a good level of product on the market. Only the secondary homes market is suffering. Activity could gradually return but will continue to struggle due to the imposition of a high capital gains tax.

Real estate support measures for both new and established homes should continue throughout 2017. In fact, real estate should remain an active sector due to ongoing availability of zero-rate loans, the continuation of Pinel scheme and the 'refuge value' effect linked to the tangible nature of property investment. Credit rates should remain low in terms of the historic average but levels have started to rise and could continue to do so. This outlook has contributed to sustaining activity since the beginning of the year. Transactions should therefore only see a slight increase in 2017 compared with the high volumes recorded in 2016. Householders could see a decrease in solvency as they have now entered into a phase of capital repayments against contracted loans. There should still be plenty of sales leading to further price increases for both new and established homes.

Annual growth rate of housing prices in France
(seasonally adjusted)



Source: INSEE - LF GREIM Research, March 2017

FOCUS ON

New technology companies, major players in the rental markets

In recent years, new technology companies have been one of the main drivers of growth in most of the main European economies. At the end of 2016, three of the five largest stock exchange capitalisations in the world and seven of the ten largest start-ups in the world were 'multi-sided platforms'. According to Jean Tirole, the 2014 winner of the Nobel Prize for economics, "a multi-sided platform is an intermediary that enables users to interact". In addition, these companies play a major role in office demand and have had a strong impact on transactions.

Since the financial crisis, there has been a considerable change in the structure of take-up by sector in the main European markets. While financial institutions dominated transactions in 2006, they were only in third place in 2016 as their level of take-up had halved. Transactions are currently evenly split between four sectors: service companies, new technology companies, finance and industry. This balanced distribution significantly reduces the risk of strong variations in transaction volumes and rents.

In 2016, new technology companies accounted for 20% of take-up in Germany with levels having increased considerably over the previous three years. In London and Amsterdam, these companies accounted for the majority of transactions. Leases by new technology companies saw the strongest increases in the London and in Berlin. In the Greater Paris Region, the main office occupiers were traditional players such as financial institutions and service companies. New technology companies have accounted for an average of 9% of take-up for the last 10 years. In terms of volume of space leased, Paris is the second most sought-after city in Europe after London, followed by Berlin, Munich and Amsterdam.

These digital companies look for space in the most active districts of Paris that offer a combination of offices, restaurants, bars, public transport and housing. Examples include Facebook, Airbnb, WeWork and Blablacar who have recently taken space in the 2nd and 4th districts of Paris at very high rents (€770 per sq m per year). Accessibility and user-friendliness are the main drivers, although less and less space is being allocated per employee.

Running against the trend seen at the beginning of the millennium, current activity by these companies has had far more of an impact on the market in terms of their behaviour rather than the volume of pace leased. These companies place the well-being of their employees and innovation at the centre of their strategy, shaking up traditional formats and are increasingly adapting to employee needs. This means that office space needs to be modular, highly connected and offer break-out areas that encourage exchange, relationship building and creativity to attract the increasingly demanding industry talent. These behaviours are gradually being adopted by many other companies, including those in more traditional sectors who are gradually adapting their office space.

In addition, at the early stages of their development these companies are making the most of new intermediaries offering office accommodation. These 'hosts' have demonstrated their confidence in these early-stage companies by renting large spaces on long-term leases. WeWork, the global leader in co-working, has rented an office of over 1,000 sq m in the 9th district of Paris on a 12-year fixed-term lease. The owner therefore deals with the world leader in co-working rather than a multitude of more fragile entities.

In 2015, new technology companies contributed 5.5% to European GDP compared with 7.5% in the United States - and this share continues to grow. These companies should therefore continue to drive activity in European rental markets. They will mainly be interested in the best-located, high-quality buildings. Over the next few years, these buildings will therefore benefit from falling levels of incentives and market recovery in rental values.

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