FALL 2020 :
REAL ESTATE KEEPS ON TRACK

BY DANIEL WHILE, MRICS
HEAD OF RESEARCH & STRATEGY

In our last report, written during the lock-down[1], we said that the current crisis would be composed of three phases: rent collection during lockdown; the economic recession; and lastly the longer term impact of the COVID-19 crisis on the real estate sector.

The general consensus is that French real estate investment companies (SCPIs) have handled the first phase pretty well, with fund managers posting average rent collection rates of 80 to 90%. Dividends paid in the first half of 2020 were on average 90% of those paid in H1 2019, with a portion of rents sometimes set aside as a reserve for future payments.

We are now entering the second phase of the crisis, i.e. its economic impact, with soaring unemployment and the risk of a cascade of business closures. One decisive factor will be whether or not welfare compensations will be maintained, as was the French government's subsidised partial unemployment scheme, which was recently extended for another 12 months.

1/ The economy – getting out of the liquidity trap

Unlike the Crash of 1929 and the financial crisis of 2008, governments and central banks were very quick to respond in proportion to the magnitude of the anticipated recession, with a 10.1% drop in French GDP forecast for 2020[2]. This response inaugurates **a new way of managing financial crises**, where central banks provide funding at zero interest to their national governments, which in turn use this money to make up for the income lost by households (through partial unemployment support) and businesses (through state-guaranteed loans, tax deferral and other measures). The French government's initial response was particularly massive, to the tune of €470 billion, and has since been followed by a €100 billion recovery plan, of which €40 billion was obtained under the European recovery programme.

The various «defensive» measures have been successful in avoiding a liquidity crisis in the banking system and in enabling companies to keep their employees and avoid losing their valuable skills. They also prevented a brutal surge in rental arrears that would have endangered the residential market, and in turn weakened the entire credit system. The effectiveness of the recovery plan's «offensive» measures will be critical to the success of the economic recovery and to containing the inevitable wave of bankruptcies[3].

However, the main obstacle to economic recovery in France is the retention of a large volume of household savings that is estimated to range from 75 to €100 billion and which has increased the average savings rate to nearly 30% vs. an annual average of 14.5%. These savings, which were boosted by the drop in consumer spending during the two-month lockdown and the anticipation of the COVID-19 crisis, have been invested in the most liquid investment vehicles, namely passbook savings and current accounts.

With the lockdown over, we now see that **forced savings have become precautionary savings** which have not been "liberated» for either consumer spending or investment. Cautiously watching out for the latest development in the pandemic, French savers are holding on to their savings, and are paradoxically delaying the recovery they are counting on to start spending again. An Odoxa survey showed that 53% of French people intend to «save more and/or cut back on spending» and 20% plan to «turn to safer investments». Only 17% of French people were planning to spend more. Only 9% of those surveyed said they were willing to purchase stocks to take advantage of the lower share prices.

French savers have thus found themselves in a «liquidity trap", where savings are retained and cannot support economic activity, despite the fact that liquid savings has never returned so little. Of course, a dramatic turn of events – such as a vaccine, an effective treatment or the pandemic's disappearance – could brighten the outlook for savers, provided it is indeed a turn for the better!

Furthermore, how can savings be redeployed and what role can real estate play if crisis constraints need to be maintained for an extended period, even if less severe?

1. Primonial REIM Research & Strategy, 8 May 2020, French real-estate market - a pre-opening inventory.
2. Source: Oxford Economics
3. Altares forecasts nearly 60,000 business failures between mid-2020 and mid-2021.

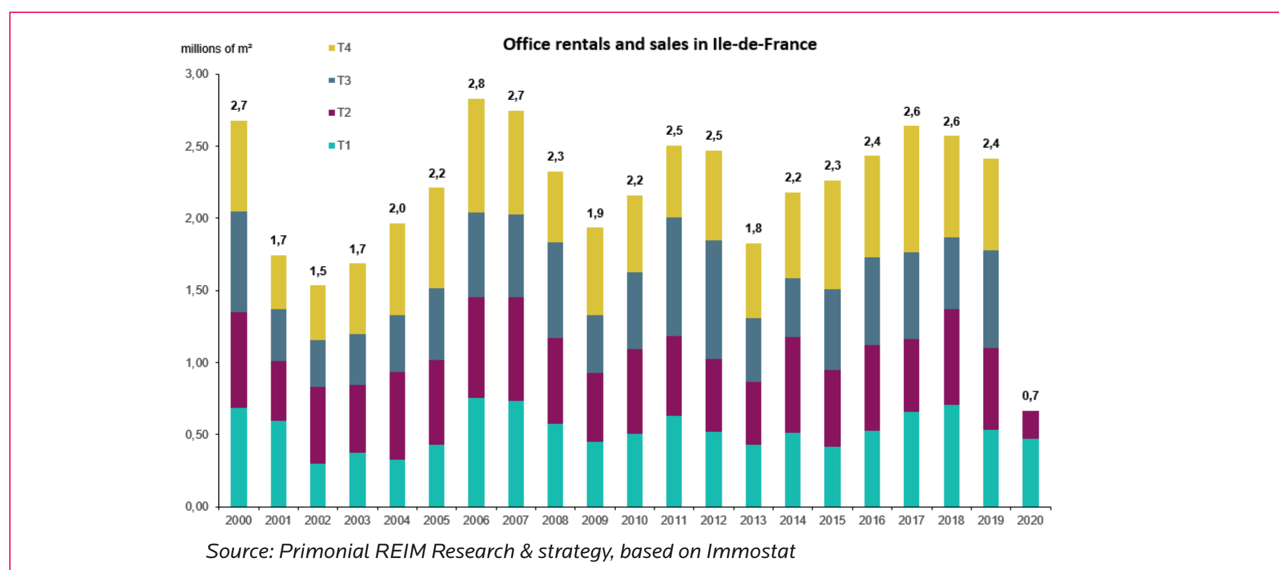
2/ Real estate – first endure, then sustain

The recently published data at 30 June 2020 provide an initial measure of the impact of the COVID-19 crisis on real property markets. Investment in France totalled €15 billion in the first half of the year, of which the second quarter accounted for almost €5.6 billion, which is more than the annual average over the past ten years. This figure above all reflects the signing of deals that were initiated before the lockdown. And yet we can see that investment has not ceased. There is therefore little chance of seeing a replay of the situation observed in 2008-2009, which was marked by forced sales due to the triggering of loan covenants, and significant asset write-downs due to a lack of liquidity.

This supports our belief that it is the «**numerator**» in the yield equation, i.e. rental income, that is the heart of the matter. As for property values, they continue to be supported by central bank policy to maintain low interest rates, which was not the case in 2008 and 2009. Furthermore, since the 2008 global financial crisis, the commercial property market has grown tremendously and the volume of investment in the first two quarters of 2020 is already equivalent to the whole of 2010! As we have already written[4], the resilience of real estate assets gives them specific advantages in the current crisis.

The recently published data for 30 June 2020 show that transaction yields for office space are stable at historically low levels: 2.80% for offices in the central business district of Paris, 3.25% for the Paris Western Crescent, and 3.50% for Lyon. Only retail properties continued to see a further increase in yields, but this was already underway in the 4th quarter of 2019 .

COVID-19 is mainly affecting the rental market. The demand for premises (in m^2 leased) contracted sharply in the first half of the year and was down 40% compared with the first half of 2019. The market environment is not favourable to leasing. Compliance with safety measures is resulting in the de-densification of office space. At this stage of the crisis, teleworking is an expedient rather than a real alternative to office work. The unpredictability of the COVID-19 crisis and consequently of future space requirements have put the rental market on hold.



Source: Primonial REIM Research & strategy, based on Immostat

However, it should be noted that **France is leading the way back to the office.** According to a study conducted by Morgan Stanley, 83% of French office workers answered Yes to the question «have you returned to your usual place of work?". This figure is 76% for Italians, 70% for Germans, 34% for the UK and 68% for Europeans in general.

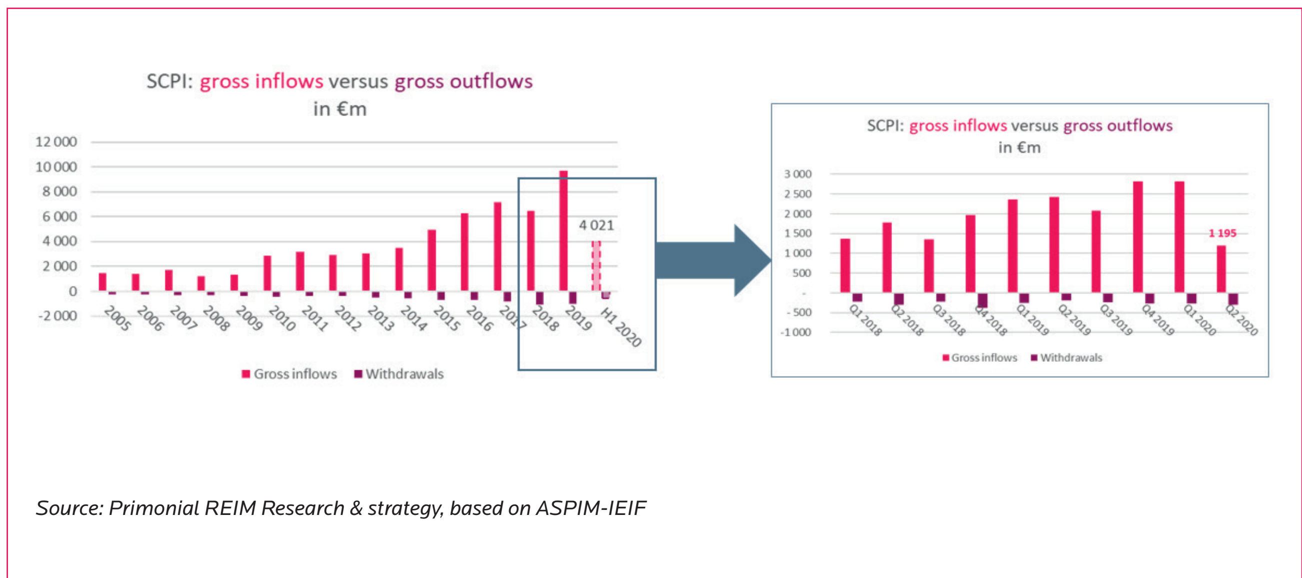
The rental market's current difficulties should encourage property managers to make efforts to retain their tenants, as the economic crisis and protective health measures have made it much more difficult to sell vacant space. These difficulties should also encourage investors to prefer mature properties that are leased to solvent companies, to the detriment of new developments that are not pre-leased, and above all vacant properties. Geographically speaking, markets with low vacancy rates (such as inner Paris and the West Crescent) are more likely to maintain their rental values than those with high rates (such as Boucle Nord des Hauts-de-Seine and Péri-Défense) or which will see massive deliveries of new properties over the coming months and years (La Défense and Saint-Denis). In the latter two municipalities, the prices of older and/or obsolete buildings are likely to be depressed by the new properties that will soon be delivered.

4. Primonial REIM Research & Strategy, June 2020, Les fonds immobiliers non cotés face au deuxième tour de la crise – la résistance des valeurs

3/ SCPI funds – what have we learned the first half of 2020?

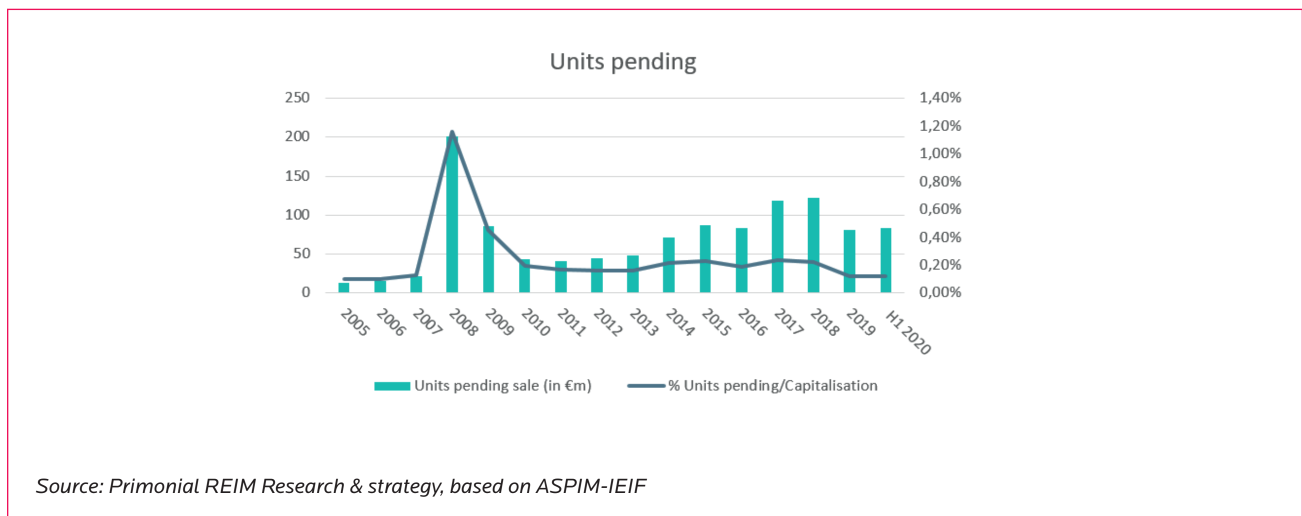
The recently published fund statistics for the first half of 2020 show a net inflow of €3.4 billion, consisting of €2.55 billion in the first quarter and €0.9 billion in the second. The first quarter of 2020 is the largest ever for SCPI funds in terms of net inflows. The 2nd quarter is consistent with the net inflows observed from 2010 to 2014, before falling interest rates gave SCPI funds a big boost.

Even though lockdown measures have weighed heavily on fund subscriptions and financial intermediation, gross inflows totalled almost €1.2bn in the second quarter of 2020. There was also no significant increase in withdrawals. Withdrawals offset by subscriptions totalled €304 million in the second quarter, vs. €272 million in the first, while fund units pending sale (generally on the secondary market for closed-end SCPI funds) totalled €84 million at 30 June, vs. €74 million at 31 March and €81 million at 31 December 2019. In other words, not only are SCPI outflows significantly lower than inflows, thereby precluding liquidity risk, outflows are not increasing.



Source: Primonial REIM Research & strategy, based on ASPIM-IEIF

The comparison with the financial crisis of 2008 is enlightening. The volume of units pending sale was significantly greater, both in absolute terms and as a percentage of the sector's market capitalisation. This does not rule out occasional liquidity issues on a few funds (as were seen in late 2008), but confirms the viability of the SCPI business model, i.e. unlisted real estate funds with extremely granular liabilities and whose inflows offset outflows.



Source: Primonial REIM Research & strategy, based on ASPIM-IEIF

The resilience of SCPI funds also reflects the investor trust they have earned. **Investors seem to have understood the role that SCPIs can play in an investment portfolio, by providing higher returns than the ever-decreasing yields of risk-free investments, with relatively low volatility and in exchange for some liquidity risk.**

Conclusion – getting through the crisis with a longer term perspective

There are now several reasons why retail and institutional investors should increase their exposure to real estate:

- **To take advantage of the low interest rate environment,** which reduces the returns of risk-free investments and makes borrowing profitable when rental yields exceed interest rates, which is definitely now the case.
- **Looking beyond the pivotal period of 2020-2022.** Several unforeseeable and extremely important events may or may not take place over the coming months, such as the development of a vaccine or treatment that could determine the future of the COVID-19 crisis, new epidemic waves, the US elections, etc. Against this backdrop, investors who want to avoid being overly dependent on these contingencies can either hold onto their cash or invest in real estate assets, which inherently offer consistent returns over the long term for several reasons, regular rental income under lease agreements, the fact that properties are not traded in financial markets, and the relative slow pace of demographic and geographic change.
- **Investing in the most resilient real estate assets.** The current health crisis has resulted in an asymmetrical economic crisis that weighs heavily on businesses that are dependent on tourism (e.g. hotels and airlines), have relatively little capital (small and mid-size businesses) and bring people into contact with each other (events, shopping centres and restaurants). Conversely, large companies that lease office premises have more cash and more diversified business activities and can therefore better withstand the current business environment. Back in March of this year, we categorised properties in terms of their resilience to the COVID-19 crisis[5]. This classification, which is still relevant, divides real estate assets into two segments:

◆ «Core» assets, which include offices leased to large companies, health-care facilities and senior housing, residential properties in large cities and the emerging urban centres of Greater Paris, and essential retail activities in prime locations of conurbations with favourable demographics.

◆ «Opportunistic» assets which are going to have to reinvent themselves, and whose yields were already rising, such as shopping malls, retail parks, and tourist and business hotels.

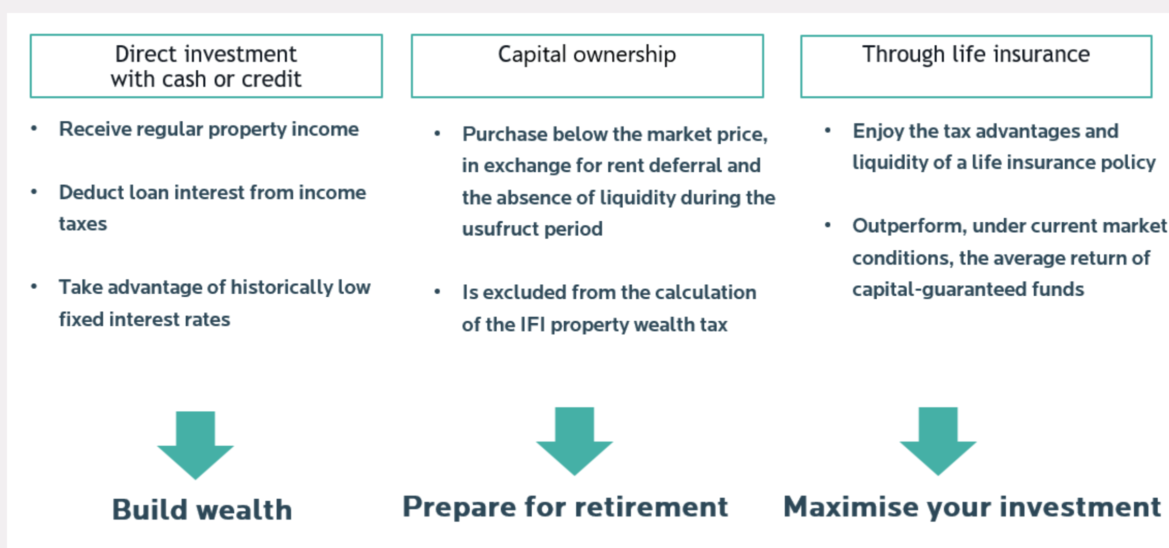
5. Primonial REIM Research & strategy, 12 March 2020, Global pandemic: is real estate a safe haven?

Three ways to invest in an SCPI fund

As our analysis shows, the pandemic crisis **has reshuffled the deck when it comes to investing in real estate**. The preference for liquidity has been hit hard by the increasingly low yields of risk-free assets, such as the interest paid on Livret A savings accounts (0.50%) and life insurance(1.50% in 2019 and expected to fall further in 2020). However, the fall in yields and above all the likelihood that they will remain low for the foreseeable future opens up a window of opportunity for SCPIs and other real estate investment vehicles. It should be noted that the average return[6] of SCPIs, after management fees and before taxes, was 4.40% and is expected to be about 4% in 2020.

SCPIs offer specific advantages. The first of these is the pooling of rental risk: the impact of the loss a tenant is inversely proportion to the size of the property portfolio. The second advantage is the fact that fund units cost only a few hundred euros. This means that investors can buy and sell them much, much more easily than they can an individual property.

But although SCPIs are relatively simple investment vehicles, there are three different ways they may be used, depending on the investor's personal situation. **It should be noted that investing in an SCPI fund entails capital and liquidity risk and requires the assistance of a financial advisor.**



6. Payout ratio by market value: the ratios of dividend payments for a given year over the average price of a fund unit during that year.

Primonial Real Estate Investment Management (PREIM) is a portfolio management company authorised by the Autorité des Marchés Financiers (AMF - French Financial Markets Authority) on 16 December 2011.

It received AIFM authorisation on 10 June 2014. Its business consists of creating, structuring and managing long-term real estate investments for individual and institutional investors.

Primonial REIM has a comprehensive range of expertise:

- multi-product: SCPI, OPCI and SCI funds,
- multi-sector: offices, retail outlets, residential assets, hotels, and healthcare and education facility real estate,
- multi-national: France, Germany, Spain, Italy, Belgium, Ireland, Netherlands.

At 30 June 2020, Primonial REIM had:

- More than €22 billion of assets under management,
- 70,170 associates,
- 45 independent real estate advisors,
- Assets worth 4,392,387 sq. m. and 7,000 tenants, including a large share of major corporate tenants (e.g. Samsung, Korian, Crédit Agricole and SNCF).

www.primonialreim.com

PRIMONIAL REAL ESTATE INVESTMENT MANAGEMENT

A Société Anonyme (public limited company) with Management and Supervisory Boards and share capital of €825,100. Registered in the Paris Trade and Companies Register under No. 531 231 124. A portfolio management company authorised by the AMF on 16 December 2011 under No. GP 11 000043. AIFM authorisation granted on 10 June 2014. Professional licences "Real estate and business asset transactions" No. T15813 and "Real estate management" No. G6386 issued by the Paris Préfecture de Police and guaranteed by the company CNA Insurance Company Ltd, located at 52-54 rue de la victoire - 75008 Paris.

HEADQUARTER OFFICE

36 rue de Naples - 75008 Paris

www.primonialreim.com

CONTACT

DÉPARTEMENT RECHERCHE & STRATÉGIE
RESEARCH & STRATEGY DEPARTMENT

Daniel While • Head of Research & Strategy • daniel.while@primonial.fr
Henry-Aurélien Natter • Head of Research • henry-aurelien.natter@primonial.fr

The Research & Strategy Department's role is to formalise Primonial REIM's real estate investment strategies, based on continuous monitoring of the French and European markets. Although collective real estate accounts for a growing share of institutional portfolios and household savings, it is at the crossroads of financial (hierarchy of rates), economic (tenants' business models), demographic (the metropolisation phenomenon) and societal (changes in usage) factors. This is why a cross-cutting analysis is needed, which is also long term and therefore in keeping with the horizon of most real estate investors.

Ref.: Research & Strategy Letter - PREIM - 092020 - DC03285. Photos: Primonial and Shutterstock