PRIMONIAL REIM

20TH TO 24TH APRIL 2020

WEEKLY REPORT COVID-19

THE NEW NORMAL IN THE OFFICE MARKET

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The world is experiencing an unprecedented crisis. Information is evolving continually, and we therefore deemed it useful to provide a weekly update on our view of events and of their impact on the real estate markets. Such is the purpose of this report which we will send you each Friday. It is a non-binding document and exclusively reflects Primonial REIM's market sentiment based on the information available at the time of writing. You can find all the reports written by Primonial REIM's Research & Strategy department at https://www.primonialreim.com/etudes and all our reports on the subject of Covid-19 at https://www.primonialreim.com/covid-19-coronavirus.

Week of 20th to 24th April 2020.

Economic environment: the latest information

- The International Monetary Fund has named this crisis «The Great Lockdown» and on 17th April it lowered its economic growth projections for 2020: -3% for the global economy, -7.5% for the eurozone, -7.2% for France. Xerfi, a market research institute, has issued a similar forecast for France (-7.6%). They all agree that growth should bounce back in 2021 (+4.5% for France, according to the IMF), but the issue today is whether growth will subsequently resume its pre-crisis level or settle at a lower level because of the permanent scars left by the crisis: the debt burden, mass unemployment, precautionary savings, restrictions on global trade. Public policy will, of course, be a determining factor in all these respects.
- Procedures for easing quarantine measures are taking shape in Europe. Needless to say, they will involve social distancing for quite some time. The dates announced for lifting lockdowns range from 14th April (Austria) to 11th May (France). We are now already able to distinguish between European countries according to how well they are weathering the crisis:

  o Those that are faring best: Germany, Norway, Greece, Austria, Iceland, Portugal.

  o Those that are struggling the most: Italy, France, Spain, the UK, where the number of deaths is at best levelling off.

There will be less chance of a coordinated European recovery if the impact varies too much from one country to another, as already observed during the Eurogroup meetings held to discuss coronabonds.

- The oil price has experienced an unprecedented crash, triggered by a collapse in demand on account of the health crisis and by saturated storage capacity.

1. Office real estate: a shock in three rounds

Office space has been the flagship product for institutional property investors in France for the past 20 years. Each year it accounts for about 60% of the total amount invested in real estate, a share that rises to 70% for commercial real estate. It therefore represents the lion's share of real estate owned by institutional investors. Such investors generally hold office assets for long periods of time (8-10 years) and their aim is to generate a steady flow of rental income from them. This is why they have opted for ***core*** transactions in mature locations rather than more speculative transactions. During the 2010-2020 period, yield compression nonetheless resulted in substantial potential capital gains for investors who took up positions early on in the cycle[1].

The Great Lockdown[2] did not immediately have much of an impact on rent collection in the office segment, contrary to the retail and hotel segments. Most of the office properties owned by institutional investors (leased to large companies in mature rental markets) have suffered less than smaller office properties leased to SMEs. Large

[1] *Cf. Primonial REIM Research & Strategy, October 2019, Bureaux en Ile-de-France : nouveau cycle, nouvelles stratégies (Office real estate in the Paris region: a new cycle, new strategies)*
[2] *Term used by the IMF in its «The Great Lockdown" report from April 2020*

firms have clearly been at an advantage thanks to their Business Continuity Plans, healthy cash positions and diversified business profiles. From a real estate perspective, ***core*** strategies have paid off.

As far as investment is concerned, dealflow in the office real estate segment continues as transactions initiated before March are now in the process of being finalised. Investors have generally adopted a «wait & see» approach, but many of them are still signing letters of interest; a certain number of office property transactions have been completed ahead since March based on valuation levels consistent with previous capitalisation rates. **In any case, there is currently no shortage of liquidity in the office market.**

We can also see that financing terms are being tightened slightly. Certain banks are taking note of the overall risk hanging over the economic climate and a perceived syndication risk and are thus demanding additional margin, although their provision of financing for property transactions remains intact.

However, while the effects of «round 1» of The Great Lockdown on the amounts invested in office property can easily be absorbed, that does not necessarily mean the office market is immune to Covid-19. We need to prepare, as far as possible, for:

- the impact of «round 2», i.e. the effects of an economic crisis on tenants and therefore on cash flow risk, as well as a denominator effect.
- the impact of «round 3», i.e. new uses for office assets that may emerge from this health crisis.

2. Office space facing round 2

The effects of round 2 are trickier to predict in the current situation because they depend largely on public policy (stimulus plans, economic reforms, etc.), which in turn depends largely on how the health crisis itself evolves (arrival of a vaccine, a second wave, etc.). For example, a succession of lockdowns if the virus ebbs and flows would make a W-shaped recovery more likely.

At the moment, the government is propping up the cash positions of struggling companies via loan guarantees and short-time work measures. We do not know when this support will be withdrawn, nor which public policies will be introduced at that time. So there is a lot of uncertainty about the number of business bankruptcies, receiverships and other liquidations.

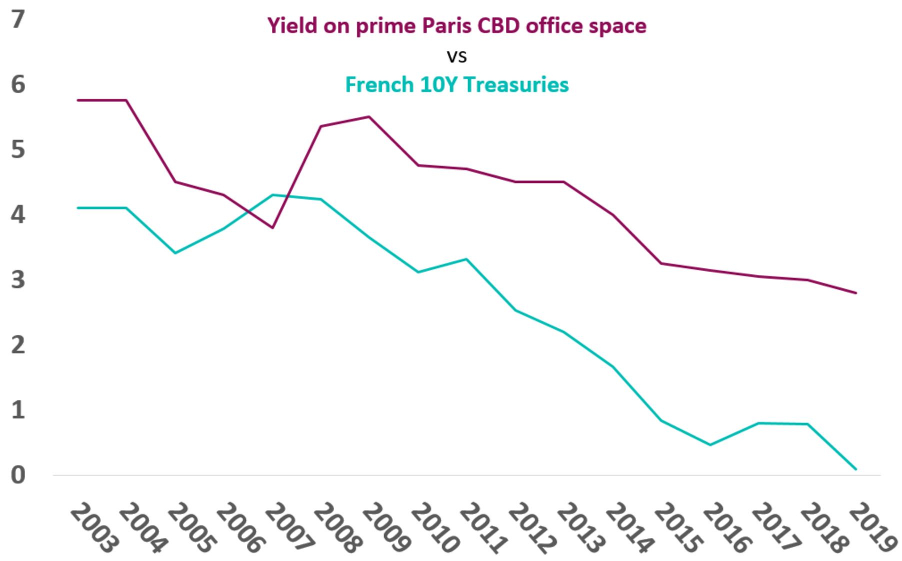
What should we keep an eye on?

- **Employment.** The most relevant leading indicator for rental demand has always been job growth (especially jobs in the service industry). Above all it is the net balance between job creation and job destruction that makes it possible to quantify the pressure exerted on office rents.
- **Forced selling.** Among the factors that exacerbated the drop in asset values in 2008-2009 was the forced sale of buildings triggered by breaches of banking covenants[3] or, where landlords were concerned, by a pressing need to reduce debt, as well as a denominator effect[4]. This has not been the case at this time, but it is something to watch closely.
- **Rental risk assessment.** During the impending economic crisis, it is highly likely that the risk premium applied to rental income volatility will be scrupulously examined and reinforced accordingly. Will businesses be inclined to sign long-term leases? How will they gauge the number of square metres they need at a time when work practices might change rapidly? What makes their business model resilient? How will landlords and tenants share out the costs of dealing with health risks (disinfection of premises, protective fittings/equipment, contactless services, etc.)? Such questions are bound to arise. We can certainly assume that investors will be very keen indeed on assets with long-term leases signed with financially sound companies.

It is worth noting that the office property market will go into round 2 on a much stronger footing than during the crisis of 2008, for at least two reasons:

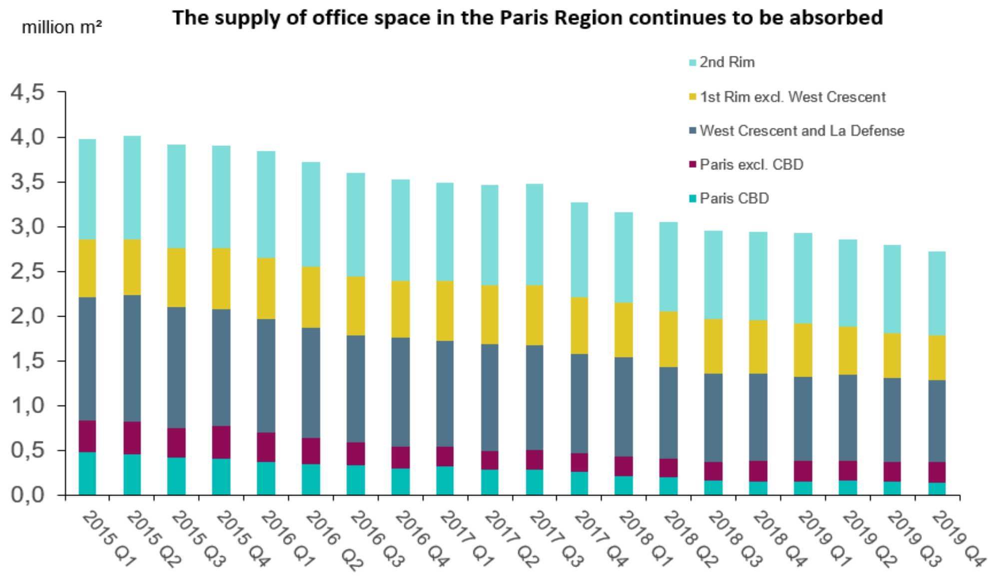
- The 2008 crisis was a financial one and directly affected the valuations of different asset classes. In 2008, the risk premium on ***prime*** CBD office space was zero or negative. So, to a large extent, the 2008 crisis burst a bubble that had already formed. Today, the risk premium on ***prime*** office space relative to French 10Y Treasuries stands at 270 basis points as interest rates have collapsed and are set to remain low for some time. A slight ***repricing***, if any, would bring historically high values per square metre back down to rather more moderate levels and help to keep real estate attractive from an investor's perspective without wrecking a seller's finances. This looks like a reasonable scenario at this time.

[3] A safeguard clause in a loan agreement that can force the borrower to repay the loan early under certain conditions.
[4] When institutional investors find themselves over-allocated to real estate, relative to their investment restrictions, due to a drop in the values of other assets in their portfolios (e.g. financial assets).



Source: Primonial REIM Research & Strategy according to Oxford Economics, BNP PRE

- Vacancy rates have fallen sharply in mature markets and are at historical lows in Paris. This is because take-up has remained well above the symbolic threshold of 2 million m² for the past 6 years; it is also because new supply has been rather more moderate in recent years. Vacancy rates in the Paris CBD were three times higher back in 2009 than they are now.



Source: Primonial REIM Research & Strategy according to Immostat

Our view is that office properties will remain a financial must-have for investors. It is the choice property investment for institutional investors as it is the most liquid and deepest segment of the real estate market. Based on these two criteria (volume invested, size of investable universe), the Paris region enjoys a highly dominant position in mainland Europe and is likely to keep drawing in international investors as it has done for the past two years.

Still, there are questions surrounding the concept of the office as a service. The public health crisis is not only affecting the economy indirectly; it is also having a direct impact on habits by imposing social distancing rules which now seem likely to be around for some time. This is forcing service companies to make a rapid technological leap towards remote working. So trends that were already underway are accelerating and spreading on account of the health crisis. Where will they take us?

3. Round 3: new uses being taken on board more rapidly

In Japan, the concept of *ma* (which can be loosely translated as "space" or "distance") refers to the value created when a distance, interval or silence arises between two beings. This concept is the product of a civilisation where population density has imposed strict protocols to maintain social cohesion despite promiscuity, and it could prove useful to Western countries in their approach to a post-Covid-19 world. The challenge facing us all, including businesses, is to create community ties while keeping our distance.

The new uses that will thus emerge (digital nomadism, the flex office, remote working, etc.) lie at the intersection between the financial rationality of businesses on the one hand and changing working practices on the other[5]. We can approach them from two angles:

- **Financial optimisation via the workspace.** Real estate costs are a company's second biggest expense, after staff costs. So the way in which a company conducts its business within a property can be a major source of savings if its financial headroom is being squeezed. Companies have clearly been able to generate substantial savings by adjusting occupancy rates, pooling fixed costs, etc. The average space allocation ratio in quality office space in the Paris region is 11 m^2 per workstation. It is steadily decreasing and, in some of the more advanced buildings, has reached 7 m^2 per workstation. This ratio varies depending on the business sector in question.
- **Transformation of working hours.** There have been calls to adjust our work-life balance and reconcile our working lives with our private lives as employees become better qualified, women account for a larger share of the workforce, society becomes more individualised, working hours decrease, etc. This is particularly true of *knowledge workers*[6] in urban areas where commuting times are long. This is why, for example, certain services (dry cleaning, relaxation, etc.) that previously formed part of one's private life have appeared in office buildings; this means that the time taken to consume such services need not be deducted from one's working hours.

The implicit agreement between a company and its employee could essentially be summarised as follows: The company optimises its space; the employee optimises his/her time. Technology is both a tool and a catalyst for these transformations.

The office, initially designed as a "tertiary sector factory" bringing together all production resources, then becomes a platform where inputs and outputs are coordinated, relations are established with other third places and, ultimately, worker mobility is reorganised.

On first analysis, we could consider remote working (as is being imposed on around a third of the economy due to the lockdown) to be the culmination of this trend. In France, just 3% of employees and 11% of professional staff make use of remote working at least one day a week[7]. Labour laws actually incorporated such changes only recently, in 2012[8] and 2017[9]. So working from home is not yet common practice. The lockdown has offered us an intensive training course in remote working… will it become the new normal?

The Yahoo syndrome. It is worth noting that these transformations are coming up against all sorts of psychological barriers: some feel a need to personalise one's workspace; a need to establish roots; a need for continuity; a need to protect one's privacy, etc. We would also mention that the link between remote working and worker productivity is by no means automatic. Yahoo set a precedent back in 2013 by making remote working a widespread practice for its staff members before then calling them back into the office. The search engine's bosses at the time put forward the following arguments[10]: a need for staff members to feel united; speed; quality; a need to share «informal» information through conversations at the coffee machine; a need for socialising and impromptu meetings.

The productivity of remote workers operating in less-than-optimal conditions during the lockdown remains to be assessed. We must also assess how much would need to be invested if remote working were to become common

[5] To quote from ARSEG in its 2018 report: "The working environment is both a cost that needs to be optimised and a resource for staff members that needs to be maximised".
[6] Workers whose raw material is information. Term first used by Peter Drucker in 1959.
[7] Source: DARES, November 2019, Le télétravail permet-il d'améliorer les conditions de travail des cadres ? (Does remote working improve working conditions for professional staff?).
[8] Bill n° 2012-387 of 22nd March 2012 on simplifying labour laws and streamlining administrative procedures.
[9] Order n°2017-1387 of 22nd September 2017 on planning and securing labour relations, ratified by Bill n°2018-217 of 29th March 2018
[10] Memo from Yahoo's management, accessible here: http://allthingsd.com/20130222/physically-together-heres-the-internal-yahoo-no-work-from-home-memo-which-extends-beyond-remote-workers/

practice: manager training; IT equipment; internet network bandwidth; mobility management; not forgetting internal control procedures, for instance with respect to managing personal data, signing documents, the right to disconnect, etc. Optimising workspace may deliver benefits in the long term but incurs costs in the short term.

In any case, as soon as the lockdown ends, service companies will have to find the right balance between lower density (in order to maintain social distancing) and remote working. But faster adoption of remote working will not necessarily disrupt the concept of the office as a service.

3. Conclusion: what does all this mean for office property investors?

What are the initial key takeways for institutional office property investors at this stage of the health and economic crisis, on the (widely accepted) assumption that social distancing measures are here to stay for some time?

- **Incorporate health aspects into *due diligence* more effectively.** It is up to the tenant to reorganise the premises according to its requirements, but many variables depend directly on the landlord or developer: air quality, first and foremost[11], but also technology that minimises contact such as handle-free doors, hands-free interphones, cleaning protocols, etc.
- **Re-evaluate the tenant's importance** based on its capacity to honour a long-term lease with the building in question: this involves assessing the tenant's financial viability, of course, but also optimising its surface area and its potential for remote working. Note that the larger occupants in Paris come from sectors that are eminently well-suited to remote working[12]: Finance, Insurance, Utilities…
- **Factor in usage obsolescence** as well as building obsolescence. A building's capacity to reduce its sqm per employee ratio while maintaining social distancing and to incorporate service areas and connected devices will be conducive to its adaptability and therefore to its future value.

For office properties as well as other asset classes, the Covid-19 crisis is likely to speed up certain trends that were already underway, in some cases quite abruptly: health aspects and ESG aspects in general will be incorporated into asset values; emphasis will be placed on a property's flexibility as a means of adapting to changing work practices; connected devices will become more prominent; data will become an important aspect of asset management. Investors will need time to adjust, of course, but we can reasonably assume **this crisis will create a more pronounced – and therefore better retributed – hierarchy between *prime*, *core* and *core*+ markets, as well as between new and existing properties.** The new «normal» in the office segment could therefore be a more complex and healthier one.

[11] See Xiao Wu and Rachel Nethery, April 2020, Exposure to air pollution and COVID-19 mortality in the United States, which underlines the correlation between air pollution and vulnerability to Covid-19.
[12] Dingel and Neiman, April 2020, How many jobs can be done at home? University of Chicago.

Next meeting

You will soon be able to listen to our upcoming podcast, in the meantime please send your questions to : communicationpreim@primonial.fr

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 31 December 2019, Primonial REIM had:

- More than €21 billion of assets under management,
- 67,841 associates,
- 46 alternative real estate investment funds,
- Assets worth 4,251,623 sq. m. and 7,000 tenants, including a large share of major corporate tenants (e.g. Samsung, Korian, Crédit Agricole and SNCF).

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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.

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