4[TH] TO 8[TH] MAY 2020

WEEKLY REPORT COVID-19

FRENCH REAL-ESTATE MARKET – A PRE-OPENING INVENTORY

BY DANIEL WHILE, MRICS
HEAD OF RESEARCH & STRATEGY

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 week. 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 4th to 8th May 2020.

Economic environment: the latest information

- The main European countries have announced their reopening dates and procedures, but at this point "lockdown-light" would be a more appropriate term than "reopening". Its sector-by-sector and step-by-step pace (by profession, region and age group), along with burdensome social distancing procedures, belies the scenario of a return to normal that prevailed at the start of the crisis.
- The main uncertainty now is whether there will be a second wave of infections once the lockdown is lifted. That's why the IMF[1] has come up with various scenarios:

o A "*swoosh*" economic recovery, i.e., a global recession followed by a slow and gradual recovery if the pandemic doesn't take a path requiring a second lockdown, or if a vaccine is found soon. Under this scenario, the global recession would oscillate between -3% and -6%, depending on how well the epidemic has been brought under control by the end of June. It would be followed by a robust upturn.

o A recovery cut short by a second wave of the pandemic in early 2021: this is the so-called W-shaped scenario, which places the pandemic on a long-term trajectory and assumes far worse economic damage, with the recession spilling over into 2021.

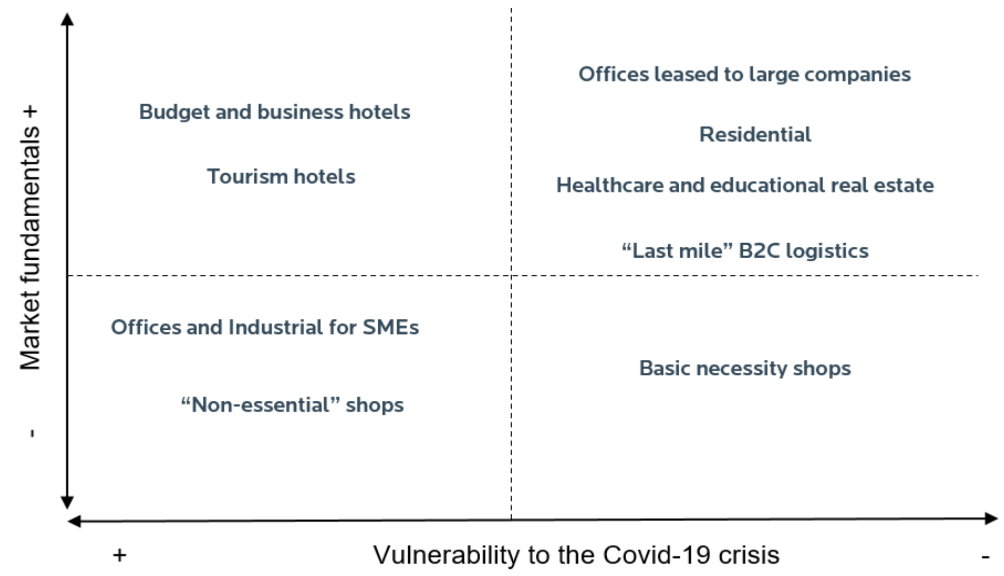
- In France, INSEE[2], the national statistics office, has fine-tuned its initial assessments while maintaining its assessment that household consumption and productive activity have declined by one third. According to *Dares*, a French public research agency, half of French employees work for a company whose business has been cut in half or been shut down completely. Unemployment benefits are therefore essential to preventing social unrest.
- The equity markets, reassured by the prospect of reopening the economy and reliable government and central bank support, have ***rallied*** in the wake of their historic plunge.

What does the dashboard look like for real-estate investors?

1/ Getting through the lockdown. In our 12 March 2020[3] report, we identified three areas to keep an eye on: monetary support from central banks, fiscal support from governments, and household confidence. On the first two points, central banks and governments have clearly been equal to the task. Household confidence, on the other hand, will depend on two crucial variables: how long the pandemic lasts and what public policies will be instituted afterwards. Since our report, the pandemic has gone global, aggravating the massive and simultaneous supply- and demand-side shocks.

There is little change to our analysis of the impact by type of real-estate asset, summarised in the table below.

[1] *IMF, April 2020, The Great Lockdown*
[2] *INSEE, 23 April 2020, Point de conjoncture*
[3] *Primonial REIM Research & Strategy, 12 March 2020, Global pandemic : is real estate a safe haven ?*



Source: Primonial REIM Research & Strategy

From the viewpoint of real-estate fundamentals, as expressed by the risk premium as of 31 December 2019, vacancy rates, and investment volumes, several segments were faring well prior to the crisis, including offices, residential, logistics, healthcare and hotels. With the exception of hotels, which were the first victim of closed borders and lockdowns, these asset classes have not had great difficulty in collecting rent during the lockdown, except in the weakest sub-segments leasing to distressed SMEs. As for retail property, keep in mind that it was already seeing the start of a squeeze in yields in the fourth quarter of 2019, after a long phase of bad news, including terrorism, demonstrations and strikes, and with death sentences being pronounced on brick-and-mortar stores.

Not all real-estate sectors have the same rent-collection issues during the first round of the crisis we are now going through. But all are being hit, directly or indirectly, by the imminent second round, meaning the looming economic recession.

2/ Getting through the reopening: avoiding the economic (and rental) domino effect. After the lockdown, the crisis will enter a second phase, a phase in which the issue of solvency – of households, companies, banks, and governments – will be a key concern. Preventing the domino effect of a cascade of bankruptcies, unemployment and credit squeezes will require keeping these economic actors at least minimally solvent.

In two months of an economic deep-freeze, household solvency has been propped up by short-time work mechanisms, and business solvency by payroll tax holidays and access to state-guaranteed financing. But the sums injected into the economy – about 100 billion euros in the case of France – are not a stimulus, but, rather, a mere stopgap. As the support measures are withdrawn, the real economy will take over. Or not. Three issues are strategic in this regard:

- **Will mass unemployment come back?** If so, the resulting shift from short-time work to no work at all would trigger a domino effect leading to a potential bank credit crunch and the transformation of a recession into a depression. What's more, the example of the US has shown that that threat of unemployment undermines popular acceptance of lockdowns and exposes countries to a simultaneous economic and health debacle. This is why we think that jobs will be maintained by governments "regardless of the price" for as long as companies have not returned to a sufficient level of revenues.
- **Will savers consume?** With 35% less consumption, almost 80 billion euros[4] in "forced" savings will have been set aside by households. Directing these savings into consumption, or at least into productive investment, is one of the keys to the recovery in a country where the savings rate is already high (15%) in normal times. Here again, public policies (disincentives in the form of a wealth tax? Incentives in the form of tax breaks for investing in the real economy?) will be decisive. Communication is also key, as risk aversion is currently at a peak.

[4] *Calculations by Xerfi-Precepta.*

- **Who's going to pay?** This is the question that will be asked of policymakers worldwide, and the question that will, for a large part, set out the future economic growth trajectory. This is not "just" a matter of who will pay the bill for the lockdown, but also who will fund the needed stimulus plan that follows each war footing. Many scenarios and proposals are currently on the table[5]. Remember that the 2008-2009 bank rescue was paid for by governments, via massive public debt. The cost of rescuing the economy can also be assumed by future generations (via debt that would be more or less mutualised), by working persons (via taxes), by savers (via inflation following on from a monetisation of debt) or by international creditors (via Covid debt cancellation). Each of these options contains risks. From the viewpoint of real-estate investors, having working persons pay down debt through taxes is the most directly threatening option for the rental markets.

The policy response to these issues will have a big impact on what happens to the real-estate "numerator", i.e., the ability of companies and households to pay their rent. The correlation between office jobs and office leasing volumes is significant. Even on an undersupplied market – the case of Paris, among others – a collapse in office demand would have inevitable impact on rent levels. Likewise, the contamination to residential real estate[6] – which is currently preserved requires that unemployment be kept low.

3/ Rediscovering real-estate prices. The real-estate "denominator", also called valuation, is also subordinated to economic growth. Remember that the 2008 crisis had an immediate impact on capitalisation rates and per-square-meter valuations. But the two crises are not comparable in this sense, for two reasons:

- Office real-estate in early 2008 offered almost no risk premium over government bonds. The overvaluation of real estate was latent, and the 2008 crisis merely reconstituted a risk premium that makes sense, one that has held until now.
- In 2020, a liquidity crisis was headed off by prompt and proportional measures. The low-interest-rate environment is generally expected to last.

So, the repricing of ***real estate*** will not come, as in 2008, with the bursting of a bubble. Appraisers will simply have to adjust existing values on the basis of two criteria: illiquidity premiums and rental risk premiums.

Repricing via the liquidity premium: not on the agenda. Office real estate is not currently suffering from an illiquidity crisis. Several deals have been done during the lockdown, and others are in the pipeline at yields similar to pre-crisis levels. The indicator to keep an eye on over the next few months is forced selling, i.e., at a price that is marked down due to exceptional circumstances, e.g.:

- Activation of banking covenants[7]. At this writing, such cases are marginal.
- The "denominator effect"[8] of institutionals. This will depend on how flexible regulators are in assessing prudential ratios.
- Deleveraging by certain large property owners hit by the crisis. This is not currently on the agenda, as large property owners are currently focused on non-real estate issues. However, the possibility cannot be ruled out that some building occupants will begin streamlining their real-estate policies in the coming months on the basis of a comprehensive policy shift reflecting health risks and the broader acceptance of remote work.

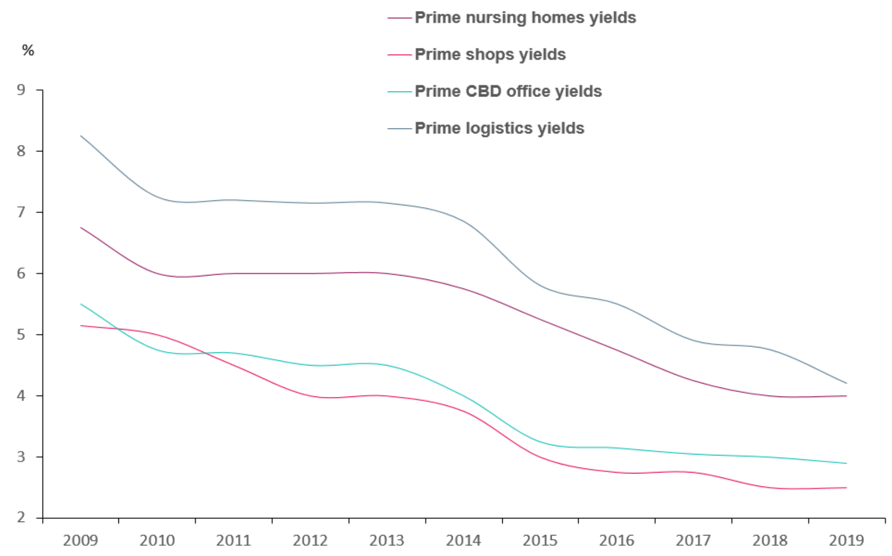
***Repricing* by leasing risk: obviously.** Most tenants will be less able to deliver cashflow than prior to the crisis. Long-dated leases will be sought out more and, hence, will be priced higher. Credit risk and cash holdings are becoming preponderant criteria in an environment where reletting vacant properties will be harder to do.

What about *repricing* of resiliency? There is now a consensus that the pandemic will transform economic practices and models for some time to come. This will obviously have an impact on the valuation of business activities. Assuming that social distancing becomes common practice, many business models will have to be reinvented to reassure consumers and employees and, perhaps, to address new demand. From this point of view, the services sector, which requires at least some contact, and shopping centres, which involve some social mixing, will be impacted, even if they are financially viable.

These three factors – liquidity, rental risk, and resilience of economic models – will be decisive in the looming ***price discovery*** phase in corporate real estate.

A convergence of interest rates in the offing? Before the pandemic, real-estate valuations were characterised by a substantial risk premium, as well as, since 2016, by a more problematic convergence of yields between commonplace assets (offices and retail) and alternative assets (healthcare and logistics). This convergence was also seen between already leased properties and new, unleased ones.

[5] See for example Jean Tirole, 1 April 2020, Quatre scénarios pour payer la facture de la crise, Les Echos
[6] See Primonial REIM Research & Strategy, April 2020, French residential: from haven to safe haven?
[7] A safeguard clause in a loan contract triggering early repayment of the loan under certain conditions.
[8] When institutional investors find themselves over-allocated to real estate, relative to their investment restrictions, due to a drop in the values of



Source: Primonial REIM Research & Strategy

Barring a brave new world of negative nominal yields, there is no valid reason for yields to continue falling. However, it likely that repricing will result in a remuneration of risk that makes a greater distinction between leased and unleased assets, between ***prime*** and ***core***, between ***core*** and ***core+***, and between ordinary and alternative properties. **Such repricing, we believe, would be healthy for the real-estate market**, as no yield-narrowing trend can erase the natural differences between liquid assets and less liquid ones.

What are some post-Covid investment themes? Given the risk aversion and ***flight-to-quality*** that normally accompany phases of economic distress, investors are likely to position themselves on core investment strategies in the coming months. The time to seize opportunities will not come until asset classes have been effectively ***repriced*** (hence, after a sufficient number of deals) and overall visibility has improved on both the health and economic fronts.

In terms of asset classes, we expect the following investment themes to increase in prominence:

- **Offices: due diligence readjusted to the context.** As the most liquid and most traditional real-estate segment, it is reasonable to expect that offices will continue to account for most investments[9], albeit with some caveats:

o Health ***due diligence*** and particularly air quality, for which recent studies[10] have demonstrated a close correlation with the transmissibility of Covid-19, as well as contact-minimising technologies;

o An assessment of tenants' economic resiliency in terms of both their cash holdings and their business activity;

o Use of office space, given the acceleration in telecommuting and the de-densification of that space (based on m² per work station and other metrics).

o More broadly, environmental ***due diligence***, which will indicate the property's ability to withstand unexpected crises.

- **Healthcare real estate: the challenge of the post-pandemic period.** We have already mentioned the major challenge of healthcare offerings, including its real-estate dimension[11]. The rallying of public-sector players (including the French national health insurance system and via the updating of the Plan Grand Age et Autonomie (a plan for autonomy of seniors) will inevitably reinforce efforts being made by private and institutional investors, especially as, in risk/return terms, healthcare properties offer the yields, decorrelation and steady cashflows that address investors' needs. These new investments will nonetheless have to factor foreseeable trends into their real-estate business plan, such as heightened medication in lodging, revaluation of medical personnel, preferences for single rooms, readjustment of mobilities to minimise contacts, and so on.

[9] See Primonial REIM Research & Strategy, April 2020, The new normal in the office market.
[10] See Xiao Wu et Rachel Nethery, April 2020, Exposure to air pollution and COVID-19 mortality in the United States. See also the recommendations released by France's Institut National de Recherche et de Sécurité
[11] See Primonial REIM Research & Strategy, April 2020, Healthcare real estate : facing the pandemic… and the world after

- **Residential real estate: the remaining source of value creation?** We have already examined the specific situation of residential real estate[12] during this crisis. If the worst-case scenario (i.e., massive unemployment) does not erase households' rental solvency, we see a clear and justified interest from institutionals for this asset class. Recent block deals (CDC and Action Logement) are a very positive indicator of this. The qualities of residential real estate (enhancement of per-square-meter value, driven by supply-side shortages, the interest-rate environment and the metropolisation trend) are aligned with the needs of many institutional investors. The issues of affordable housing and development of common services are, we feel, very relevant within this asset class.

Conclusion: first endure, then last. The true "day after" will not be the day after the lockdown ends, but the day after the vaccine is discovered. Between the reopenings and the vaccine, there will be a period, whether long or short, during which the consequences of policies conducted by all governments will be rolled out. Practices – both in real-estate and elsewhere – will shift and, with them, the behaviour of consumers (such as the expansion of home delivery) and producers (the boom in remote work).

Real-estate investors are generally positioned for almost 10 years or even more. The rent recovery rate in one quarter therefore matters little to their long-term commitment. Tenants' ability to weather one or two recession years was already a decisive factor in ultimate profitability. **But *sustainability* of the investment is now the preponderant criterion** – sustainability of territory, whether metropoles or Greater Paris, which will remain the crossroads of activity; sustainability of tenants from the point of view of their financial viability and their adjustment to new practices, and sustainability of the properties themselves with regard to preventing future risks.

[12] *See Primonial REIM Research & Strategy, April 2020, French residential: from haven to safe haven?*

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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PRIMONIAL REAL ESTATE INVESTMENT MANAGEMENT

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HEADQUARTER OFFICE

36 rue de Naples - 75008 Paris

www.primonialreim.com

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CONTACT

DÉPARTEMENT RECHERCHE & STRATÉGIE
RESEARCH & STRATEGY DEPARTMENT

Daniel While, MRICS • Head of Research & Strategy • daniel.while@primonial.fr
Henry-Aurélien Natter, MRICS • 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.

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