PRIMONIAL REIM

REAL ESTATE BETWEEN TWO CYCLES

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After a buoyant period, investment real estate is facing a new set of circumstances: the end of a low-interest rate regime and the impact of structural changes (metropolisation and a revolution in usage). What might the consequences be for fund managers and asset allocators?

What stage of the real estate cycle are we at?

This question is all the more difficult to answer as the real estate cycle is largely dependent on a hierarchy of yields disrupted by the unconventional policies introduced by central banks.

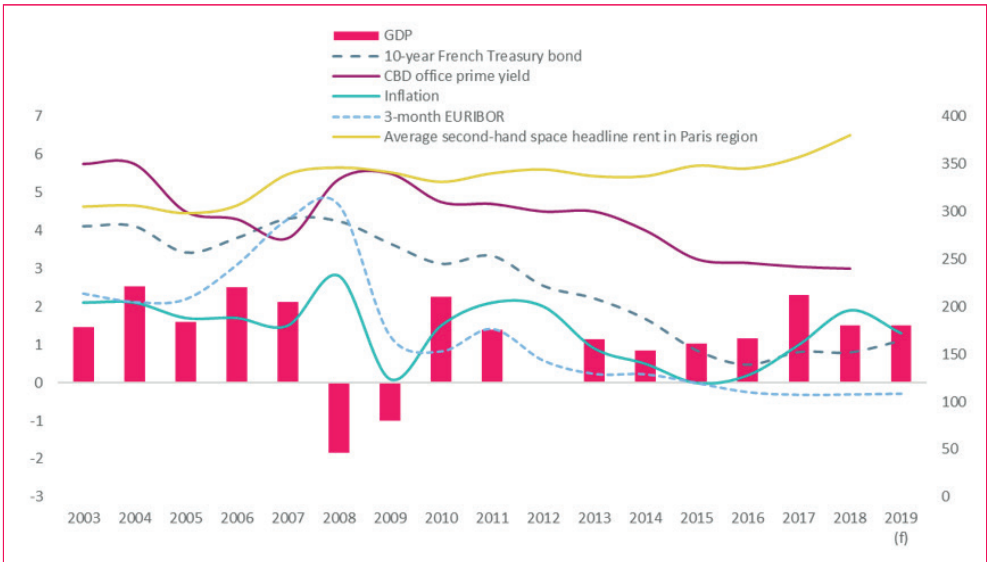
After the financial crisis in 2008, an unprecedented quantity of currency was issued with the aim of reducing interest rates and reaching an inflation level of close to 2%. These two objectives have now been achieved, or soon will be. The unknown factors are how the economy can now pull out of its dependence on central banks and the economic growth that might be expected in the next few years.

For real estate investors, the 2014-2018 period is one for the history books, given the exceptional capital inflow (with five consecutive years of investments of more than €20 billion in commercial real estate in France), the continuous value creation due to the compression of capitalisation rates, and the maintaining of a substantial risk premium. The sector fully benefited from a reweighting of real estate assets in institutional allocations towards an ideal risk/return positioning.

Real estate assets' good fortune was not necessarily sustainable over the long term, however. **Interest rate cuts alone cannot make real estate profitable**; the real economy must grow strongly enough to support the rental market and the real estate market.

DID 2016 MARK THE START OF A CHANGE IN CONDITIONS?

Since mid-2016, a number of signals have seemed to announce the current change in conditions, which we can see simply by looking at the main French economic and real estate aggregates. In 2016, the 10-year French Treasury bond and the Paris prime office yield reached a low of 0.65% for the French Treasury bond, and 3.5% for the prime yield. After moving into almost negative territory, inflation later took off as oil prices increased. The average rent in the Paris region has also been rising for the last two years, under the anticipated effect of indexing, and the moderation of new office construction, whose vacancy rate stayed low in the main local office markets. Events suggest that a Japanese-style deflationary scenario can finally be ruled out and



Sources: Primonial REIM Research &Strategy, Immostat, Oxford Economics, Banque de France, BNP PRE the scenario is now a trend rise in interest rates, subject to growth, and therefore national, European and worldwide economic policies.

Should the rise in interest rates be feared? It currently seems clear, at the start of 2019, that a sharp hike in key rates is no longer on the agenda. Structural growth in the eurozone remains relatively low, inflation is contained, and investors are significantly risk averse.

A simple projection of the deviations from the average historical risk premiums also shows that asset values may decline once a threshold of around 1.75% for the 10-year French Treasury bond has been exceeded. Recent developments in the United States provide further evidence that a rise in key rates does not automatically reduce commercial real estate yields if it is driven by economic growth. We therefore believe that only a combination of a recession, i.e. a fall in GDP, and a steep rise in the 10-year French Treasury bond yield by more than 50 bp, would really boost real estate yields.

Real estate investors should therefore be focused less on withstanding a sudden rise in short-term key rates, and more on preparing to manage a perhaps lengthy period of no cuts, or a slow rise. In such circumstances, value creation is no longer automatic, even in the best locations.

In such conditions, how should investors “play” the next real estate cycle?

TWO MACROECONOMIC SCENARIOS

REFLATION

Growth ≈ 2 %

Inflation ≈ 2 %

A moderate rise in interest rates accompanies inflation and growth

consequences for real estate:

- rise in economic rents and fall in free leases,
- an inscrease in the real estate risk premium without a significant fall in values,
- offices and retail outlets are the most sensitive sectors.

STAGFLATION

Growth < 1,5 %

Inflation ≈ 2 %

A rise in interest rates succeeds inflation but precedes and weakens growth

consequences for real estate:

- rise in rents but an inscrease in free leases,
- An increase in the real estate risk premium due to a fall in values
- reweighting of value creation assets towards residential real estate.

Two possible scenarios for the coming years may be considered for France and the eurozone: a “reflation” scenario in which GDP grows as a result of structural reforms (supply-side policy), and a stagflation scenario in which economic growth in the eurozone remains limited. Note that the growth forecasts for 2019 (1.6% for France and 1.8% for the eurozone) are equally balanced in favour of these two scenarios. In both cases, the rise in key rates appears moderate. It seems advisable to build portfolios that can come out of either scenario well.

In this new cycle, how can real estate investors create value, which used to come automatically from the compression of capitalisation rates? As each real estate transaction has its own characteristics, unilaterally applicable guidelines cannot be defined. Certain background trends should be taken into account in investment strategies in the next few years, however:

1/ **REVERSIONARY POTENTIAL WILL NOW COME FROM RENTAL INCOME** rather than the compression of rates. The health of the current rental market, the return of more advantageous indexing conditions and the shortage of supply in some markets, Paris foremost, should prompt investors to step up their developments or end-of-lease transactions in the most attractive markets with the highest take-up rates. Such a shift can already be seen, as development sales account for an increasing share of investment in the Paris region. Rent-free periods must be limited for this type of investment to be profitable quickly enough, however. The level of incentive measures is therefore an indicator that should be monitored more closely.

2/ **VALUE CREATION WILL COME FROM INVESTORS' ABILITY TO DETECT THE BEST "REGIONAL ENTRY POINTS".** The metropolisation phenomenon reshuffles the deck for the residential markets in Greater Paris, French metropolitan areas and the major European cities (see "Residential property, from metropolisation to investment strategy", Primonial REIM Research & Strategy, January 2019). This approach is all the wiser in a stagflation scenario, due to the lower correlation of residential real estate with economic cycles. Institutional investors' appetite for housing, due to the potential appreciation in value, is therefore warranted, but requires enhanced regional analyses of demographic, technological (transport infrastructure) and real estate factors.

3/ **THE REVOLUTION IN USAGE MAKES THE BUILDING A BUSINESS TOOL.** This new paradigm is affecting all asset classes, with coworking in the office market, coliving in the residential market, retail outlets versus digitisation, and inpatient healthcare versus outpatient care. Its incorporation within investment models is therefore a priority. There is no way of predicting which format will come out on top over the long term, however. Faced with the increasing pace of technological development and the disruption of business models, investors should perhaps not bet on an innovation, which are unpredictable by definition, but **jointly invest with major operators, supporting their real estate strategies in exchange for a long-term rental flow**. An investor/operator partnership approach should prevent a negative impact from the shift in usage.

4/ **NO LONGER JUST DIVERSIFYING, BUT COMBINING REAL ESTATE ASSET CLASSES.**

SCORING OF THE MAIN ASSET CLASSES

ASSET	MARKET DEPTH	CASH FLOW	VALUATION	LIQUIDITY	LOW VOLATILITY	LACK OF CORRELATION WITH ECONOMIC CYCLES
CORE/CORE+ OFFICES	3	2	1	3	3	1
VALUE-ADDED OFFICES	3	1	3	3	1	1
RETAIL (HIGH STREET SHOPS)	3	1	3	3	2	1
RETAIL (RETAIL PARKS)	2	3	1	1	1	1
HEALTHCARE (CARE HOMES)	1	2	2	1	3	3
RESIDENTIAL	1	1	2	3	3	3

1 = the lowest score > 3 = highest score
Source: Primonial REIM Research & Strategy

The table above summarises our assessment of the various types of real estate, from the viewpoint of their advantages for investors, by giving them a score from 1 to 3. It shows that offices are still a vital component of allocations. Offices best meet the institutional market depth and liquidity criteria. On the other hand, the long-term valuation criterion will no longer be automatically met by the cycle of rate compression. Institutional investors' diversification into more alternative asset classes, such as retail outlets, healthcare facilities, residential assets, logistics and hotels, which began two years ago, is entirely justified.

These approaches will necessarily be integrated within a real estate allocation approach. No asset class now ticks all of the boxes on its own when it comes to the characteristics sought by investors, namely market depth, cash flow, value, liquidity, volatility and decorrelation. They must therefore be weighted so that they can make their specific contributions to portfolios.

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 and healthcare and education facility real estate,
- multi-national: France, Germany, Spain, Italy, Belgium and Ireland.

At 31 December 2018, Primonial REIM had:

- €17.2 billion of assets under management,
- 58,920 associates,
- 43 independent real estate advisors,
- Assets worth 3,817,380 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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