PRIMONIAL REIM

13 TO 17 APRIL 2020

WEEKLY REPORT COVID-19

FRENCH RESIDENTIAL: FROM HAVEN TO SAFE HAVEN?

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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 13th to 17th April 2020.

Economic environment: the latest information

- A consensus is emerging that the lockdown exit strategy (France plans to lift its lockdown on 11th May) will involve reinforced social distancing (e.g. face masks, a ban on gatherings of people, cafés/restaurants remaining shut), systematic testing and continued quarantine for certain groups of people (senior citizens), not forgetting the continued closure of borders. It is difficult to set a time limit for these measures, especially as a hypothetical vaccine is not expected until 2021. Such an outlook means less visibility for market operators and thus dampens the expectations of consumers and businesses alike, which will have a crucial role to play as the strength of the recovery depends on them.
- Epidemiologists say a 2nd wave cannot be ruled out. There are consistent signs of the epidemic making a comeback in China. So we might see a series of lockdowns being lifted and then enforced again. This would make a W-shaped recovery more likely.
- The Eurogroup (made up of the eurozone's finance ministers) met on 9th April and agreed on an emergency fund amounting to over €500 billion. The plan has three main components: a €240 billion credit facility available via the European Stability Mechanism for healthcare spending, €100 billion for short-time work measures, and a guarantee fund enabling the European Investment Bank to lend companies a total of up to €200 billion. However, Germany and the Netherlands closed the door on debt mutualisation in the form of « coronabonds ».

1. Residential real estate before the crisis

The residential real estate segment's indicators were extremely sound before the Covid-19 crisis: transactions in the existing housing market had reached a record high (>1 million in 2019) for the second year running; prices were rising substantially but under control (+3.9% in the Paris region and +3.6% in the provinces in the 4th quarter of 2019 year-on-year); and mortgage rates were falling (-32 basis points between December 2018 and December 2019). Above all, institutional investors were still keen on block residential assets in France (€3.5bn invested in 2019) and especially across Europe (€62.7bn, of which €18.3bn in Germany despite the rent cap in Berlin). New property sales and construction starts, on the other hand, had begun to dip somewhat as they often do in the run-up to local elections.

Prices had been rising moderately but steadily since 2015 for a number of structural reasons:

- A steady decline in borrowing rates, propping up the solvency of large numbers of buyers even as prices per m² were rising. On the back of this, the "property purchasing power" of France's population increased by 36% between 2008 and 2018 according to an indicator compiled by BNP Paribas Real Estate.
- Pressure due to demand exceeding supply in many regional metropolises (Lyon, Nantes, Bordeaux) and « special housing control areas » in the Paris agglomeration. This is because of major constraints on supply (e.g. construction costs above the European

average, political restrictions on issuing building permits) but also faster urbanisation and inter-regional migration.

- Residential assets becoming a more sought-after investment. This is especially true of institutional investors as the yield spread between residential / prime office assets was almost zero at the end of 2019 compared with 350 basis points back in 2002.

This relative prosperity had prompted the HCSF (High Council for Financial Stability) to issue recommendations limiting mortgage periods (to no more than 25 years) and debt-to-income ratios (to no more than 33%) for households. Moreover, legislative reforms (the Lagleize Bill) and innovations in the market have been geared towards improving access to the residential market, without upsetting the price momentum, by deconstructing traditional property rights, through the split of land/building ownerwhip, private/common areas, lifelong detention, etc.

All these structural factors still apply during this public health crisis. However, the crisis has come as a shock and is unsettling the residential market, the economy and consumer confidence. So it is bound to have repercussions.

2. The short-term impact of the public health crisis

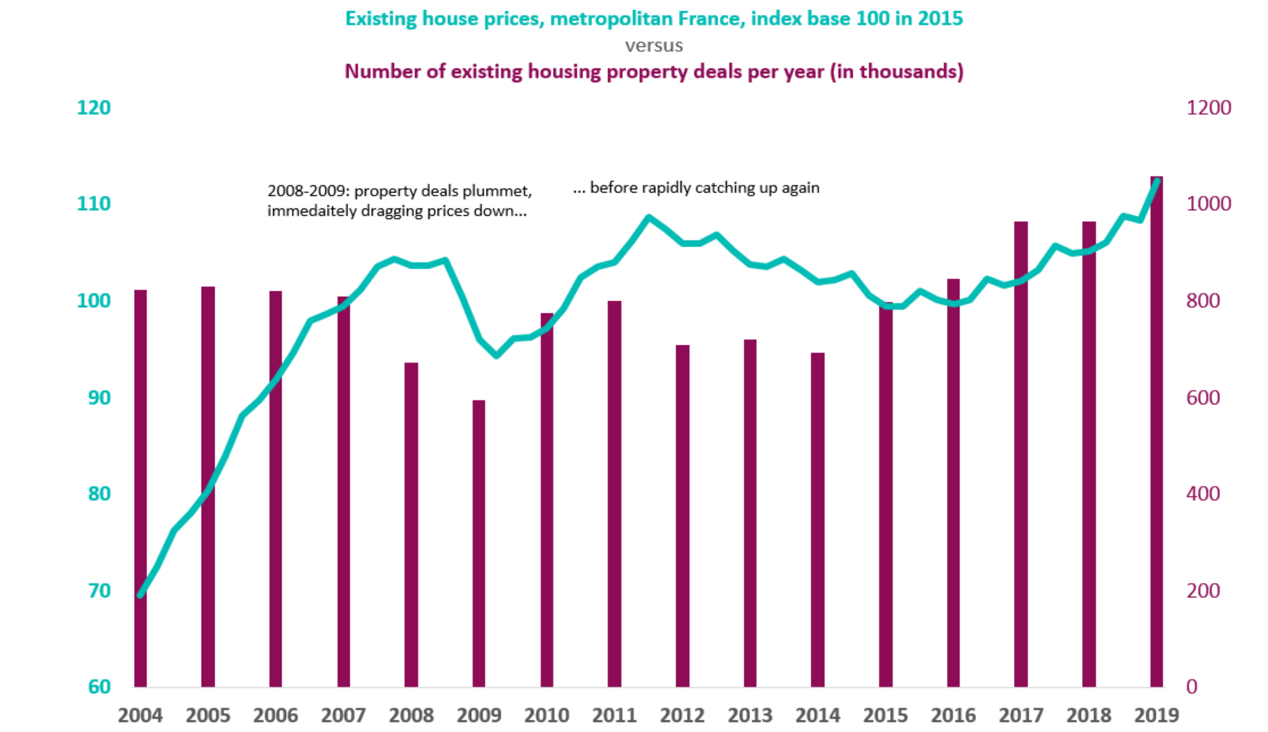
A lost year for new housing production. Developments have been suspended, putting the brakes on new housing production; this will remain the case until public health conditions have improved enough to be deemed acceptable. Construction permits had already slowed down considerably because of the upcoming local elections, which have now been postponed. It is too soon to know whether new tax devices will be introduced to prop up the sector. However, certain socially committed operators in the public market (CDC) and private market (Action Logement) have already announced that they will provide substantial support by building 50,000 residential units in the space of 12 months. In any case, the disruption to new home building is widening the supply deficit which was already considerable in « attractive locations ». We might also see programmes initially developed to be sold in units instead being bought as blocks by institutional investors lured by the attractive risk/reward profiles of such transactions.

Suspension of individual transactions in the existing housing market: a matter of confidence. If quarantine measures are indeed lifted on 11th May, then existing housing transactions will have been suspended for 2 months. March and April account for 20% of annual property transactions on average[1]; based on one million transactions recorded annually in the past two years, this corresponds to 200,000 fewer transactions. Have they been cancelled or simply postponed? This is a crucial question: will buyer confidence return? Even though individual tenants have not had their rental payments suspended, one of the features of this Covid-19 crisis is the very high degree of uncertainty hanging over economic agents. Uncertainty fuels pessimism and, worse, a resistance to change when it comes to making long-term decisions, not only whether to buy but also whether to sell. We should therefore expect the number of property transactions to be relatively lacklustre over the coming months. On the other hand, we can see no signs of massive or forced selling, either by individuals or institutional investors.

Will the mortgage market deliver? There is no guarantee of this as interest rates are at historically low levels (around 0% for the 10Y French Treasuries). Banks have already seen their operating margins eroded by low interest rates, and they will now be called on to rescue businesses and expand their margins on the expectation that debtors are going to struggle. We can assume that mortgage rates will be competitive[2] and that mortgage terms and conditions will be less so.

What are the key takeaway points from 2008? The two crises have different underlying causes – one was a financial crisis, the other is a shock to the real economy – but the same impact on the existing residential market, i.e. an almost total freeze on property transactions over a period of several months. Prices adjusted downwards at the time of the 2008 crisis but immediately recovered the lost ground the following year. Similarly, property values stalled or even fell during the years of sluggish economic growth in France (2012-2015), but they immediately recovered the lost ground when GDP growth was strong enough. All this suggests that the residential market is supported by a number of underlying factors – one obvious example being the structural imbalance between available land and household demand – which come into play as soon as growth picks up again, and assuming interest rates remain

[1] *Source: meilleursagents.com.*
[2] *Mortgage rates in April averaged 1.15% for 15-year, 1.32% for 20-year and 1.60% for 25-year mortgages.*



Source: Primonial REIM Research & Strategy according to INSEE-Notaries, FNAIM.

We would therefore not rule out the possibility that plummeting property transactions will have a mechanical impact on prices in 2020. However, the real issue is rather: will the structural factors that prop up prices continue to apply, thereby enabling the residential market to start growing again after the Covid-19 crisis?

2. Residential: what are our post-crisis scenarios?

The answer to this question seems to lie more in the macroeconomic situation than in the residential market's internal workings. It all depends on how "round 2" of the crisis is managed. We can draw up two "extreme" scenarios.

Worst-case scenario: household solvency collapses. So far, household solvency is being kept afloat by financial aid for short-time work (concerning 4 million people in France); by definition, this is a temporary situation and implies that businesses will not have to file for bankruptcy. But governments and central banks will eventually stop providing support to offset the loss of economic activity due to the lockdown; this will be the moment of truth for many companies whose capital will have taken a battering. The worst-case scenario would involve a series of bankruptcies triggering mass long-term unemployment. It would undermine households' purchasing power – including their property purchasing power – and even compromise their buying capacity. In this case, we would expect house prices to fall. Even if mortgage terms and conditions were to remain favourable, there would simply be fewer households eligible for mortgages.

Best-case scenario: residential real estate becomes the new core. Governments and central banks can avoid mass unemployment by bringing out both their fiscal and monetary arsenals at the same time. By doing so, they would enable the residential market to resume its previous moderate, but positive, momentum. Residential would typically tick a lot of boxes for institutional investors: a core performance profile, little exposure to fluctuations in rental income, relatively uncorrelated with economic cycles, and value creation that is long-term and thus consistent with demographic and urbanisation trends. Residential assets would therefore be in a good position to compete with office assets in an institutional investor's portfolio. And there are lots of local markets, both in France and across Europe, offering attractive opportunities and points of valuations[3].

Longer term, this scenario could revive inflation, a long sought-after but always unattained target since quantitative easing was first introduced to deal with the financial crisis. In this case, the academic findings and experience of the past 50 years show that residential property is the real

[3] *Cf. Primonial REIM Research & Strategy, January 2019, European residential real estate : from metropolization to investment strategy*

estate asset class that offers the best hedge against inflation because rents (as reflected in the IRL, France's benchmark rent index) are so closely correlated with property values.

Conclusion. In its physical state, residential has provided the French population with a safe haven against the pandemic; will residential prove an equally safe haven for their savings? This is already certainly the case for individuals as property accounts on average for two-thirds of a household's assets, mainly through ownership of their main residence. But property as a financial investment is far less common: about 5% of financial investments made by the French are in real estate funds[4], of which only a tiny share is invested in a residential underlying.

The qualities of residential real estate (provided they emerge intact from the economic policies introduced when this health crisis ends) will make it a more popular investment option. Individuals will be as keen as ever to own their homes, while institutional investors will become more prominent buyers of real estate; property law will offer up new forms of ownership along with measures promoting affordable housing; the population will increasingly aspire to a better quality of life that is now within their reach thanks to remote working... All this combined would put residential real estate in a prime position to become the new core asset for property investors.

[4] *Cf. Primonial REIM Research & Strategy, January 2020, Life insurance: the new real estate equation*

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 independent real estate advisors,
- 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).

www.primonialreim.com

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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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