The French Connection—Commercial Real Estate

Market Conditions

By Solly Gubbay

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Like most OECD economies, the 2009 recession bit France hard at the beginning of 2009. However the fiscal deficit as a percentage of 2009 estimated GDP was 8.2 percent, well below the United Kingdom (U.K.) at 14.5 percent and the United States (U.S.) at 11.9 percent. Those two economies were most exposed to the subprime crisis. Similarly, France's estimated 2009 GDP was minus 2.4 percent, which is half the U.K.'s expected GDP of minus 4.5 percent. Buoyed by a still-resilient consumer market and lower corporate, mortgage, and personal debt, France and Germany were the first European economies to record positive growth in the second quarter of 2009.

The Île de France (Greater Paris) Commercial Office Market

The economic dominance of France's capital, Paris, with a population of 12 million in Greater Paris, produces around 30 percent of the nation's GDP, which has created the Eurozone's largest office market by far—50 million square meters—making it comparable to London. For this reason, this report will concentrate on the Paris market.

The office occupier (tenant) market has fared well because it does not rely on any one particular occupier (tenant) sector, such as financial services, but has a diversified economic base. An unrivalled and generously publicly funded transport system, together with the concentration in Greater Paris of the nation's top universities and business schools, has underscored its attractiveness for major international corporations, which dominate the La Défense skyscraper business district.

Gross office take up (absorption) for 2009 was around 1.8 million square meters, well below the 2.75 million square meters recorded in 2007, but still much greater than comparable office markets. This is due partly to big-ticket leasing transactions, greater than 10,000 square meters, in the suburbs. For example, 200,000 square meters were leased in just 10 transactions in the western suburbs this year, including La Défense. Such regroupings and space consolidations are key to this market as transactions in central Paris CBD districts have dropped significantly. As with 2008, 2009 net office take up (absorption) was negative as these same occupiers (tenants) release space.

Overall vacancy rates are surprisingly low for a global recession of such depth: currently standing at 5.8

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percent in Paris CBD and 6.9 percent in Greater Paris. These low rates could be explained by the fact that the causes of this recession are largely financial and massive overproduction of speculative offices was not prevalent in 2007, as was the case in the real estate recession of 1992. Overall office availability is currently 4.6 million square meters of space and could easily rise to five million.

The supply of newly developed space, at around 1.2 million square meters, is still manageable. Moreover less than 30 percent of this new supply is environmentally compliant and with a quasi-halt in office building starts due to the credit crunch, the market could well be in undersupply by 2012.

Obviously headline rents have fallen, but with such fundamentals, there has been no free fall. Prime CBD rents are still 15 to 20 percent off their 2007 highs at around €600 per square meter. Similarly, suburban rents now range from around €530 per square meter in La Défense to €200 and less per square meter in outlying suburbs. For modern, environmentally compliant, large close-in suburban office buildings on public transport, there seems to be a floor on rents at around €300 per square meter because at this price, there are sufficient economies of scale to considerably reduce workstation costs.

The Investment Market

In contrast to the leasing market, recorded investment volumes barely reached €8 billion in 2009, similar to the €7.8 billion for the whole of 2008 compared to a record €20 billion in 2007. The financial crisis and ensuing severe credit crunch took their toll in a falling market. However, fourth quarter figures were a 100% improvement on the third quarter which may indicate an upturn for European institutional investors, principally French and German, who were in the majority and essentially have investing 100 percent equity in fully-leased properties.

German open- and closed-end funds, traditionally a mainstay in European markets, have begun to return. In the second half of 2009, around €500 million in total investments were recorded, principally in CBD Paris.

Again, deals greater than €50 million, which were non-existent during the first half of the year, are beginning to return as banks begin to lend again, albeit at nowhere near the 70- to 80-percent loan-to-equity ratios prevalent in 2006–7. As of the third quarter, there were seven transactions greater than €50 million, of which four were larger than €100 million.

Unlike Anglo-Saxon markets, there have been relatively few loan defaults. There could well be severe valuation issues between lenders and borrowers given the fall in prices, but as long as these properties are leased, these situations are manageable.

Net initial yields in CBD Paris are currently between 5.5 and 6 percent with suburban yields at 7 to 8 percent. More importantly, the CBD risk premium compared to long-term government bonds, at around 250 basis points, has rarely been so great. This factor, coupled with basically zero returns on short-term cash deposits, makes a compelling case for commercial real estate, which also provides a hedge any future inflation.

Future Trends

It is generally accepted that all markets recover. However, the difficulty lies in timing, whether forecasting further weakness or timing the turnaround.

Although, the Paris market has seemed more resilient during this severe recession than comparable markets in the U. S. or the U. K., it may well be that Paris will take longer to recover to previous highs either in gross take up (absorption) or rents. For example, London, especially the City and West End where rents fell by more than 50 percent from 2006 highs as a direct result of the financial crisis, may well recover more steeply than imagined. It is the stability and inherent resilience of the Paris Occupier (Tenant) market that could set it apart. Gross take up (absorption) could well continue to fall in 2010 to, say, 1.5 million square meters, but this would still be considered sizeable activity in any market. Next year should also continue to see space consolidation (including within the public sector), which will generate large office requirements. Similarly, rents may continue to weaken, but given the low vacancy rates, especially in the CBD, they may find a floor in 2010. However, just as the French economy is less elastic than in Anglo-Saxon countries, it may take more time to approach previous highs.

In the investment market, global investors could soon be comparing current trends in London—where prices have recovered around 15 percent in 2009—to Paris in 2010, where international investors may well increase their presence and put pressure on yields.

The quoted property sector, often a leading indicator, has already performed well, rising from lows recorded in March 2009.

1€=1.3589 U.S. dollars