A new world for real estate investors

As the world changes, progressive real estate asset managers are discovering new opportunities

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Real estate rental market activity across Europe is flying high as business climate indicators hit their highest levels since the end of the recession in 2010-11. Investment has remained very strong, with €130 billion in investment[1], making H1 2017 one of the top two years since 2006 in terms of H1 performance. However, the headline figures mask some interesting geographical differences. The German investment market experienced a record-breaking start to the year with €26 billion in investment—up 44 percent on H1 2016. In the UK market, which is adjusting to the fallout from the EU referendum, investment nevertheless rose by 23 percent on H1 2016 to €44 billion.

1. Source: CBRE, LF GREIM Research

Meanwhile, in France, the rental market made a timid start to 2017. Real estate investment reached €9 billion over H1—stable compared with H1 2016. A broad desire for home ownership and historically low interest rates are expected to continue to underpin the French residential real estate market, leading to further price increases for both new and established homes. High demand from French home buyers is increasingly concentrated in cities. The most striking example of this is the greater Paris area, where despite a series of crises since 2008, prices have generally risen and are expected to hit new records in 2017. As a result, the share of expenditure on housing has soared, limiting household budgets allocated to other areas and acting as a drag on French economic growth. By contrast, analysts point to the strength of the German economy, where a better distribution of activity and residential areas across the country are increasing competitiveness and boosting household consumption by maintaining rents at reasonable levels.

Grand Paris

The Grand Paris project, an ambitious infrastructure project on a scale not seen in the French capital since the 19th century, has been developed to address some of the challenges facing the French rental market. It is also a good example of a new phase in the real estate development cycle, which is opening the door for real estate investment managers to broaden their activity from the acquisition, management, and sale of assets to the financing of development projects. The high-quality urban project has a budget of €25-35 billion to almost double the transport infrastructure around Paris, and this should generate investment in the construction of housing and offices totaling €75 billion.

This is partially financed by La Française Group, a French asset manager with €64 billion in assets under management that made €2 billion in investment in France and the euro zone in 2017—a substantial long-term commitment that means it is invited to tender for all major projects in the market. "Our group is not just active in asset management; with real estate assets of €15 billion in Europe and more than 500 assets in the Paris region (Île-de-France), we also possess a significant amount of land assets," says Chairman of the Board of La Française Group, Xavier Lépine. "It was, therefore, natural for us to participate in this monumental project, which has no equivalent in Europe."

Paris has not experienced changes on such a scale since 1860 when Napoleon III officially annexed the suburbs of Paris out to the ring of fortifications around the city, leading his prefect of the Seine, Georges-Eugène Haussmann, to enlarge his vast public works program and construct new boulevards to connect the new arrondissements with the center. As part of the Grand Paris strategy to better connect the French capital's banlieues with its center, and manage the city more inclusively, work is underway on the Grand Paris Express, which will expand the century-old metro system to include four new lines, 68 stations, and more than 120 miles of track. Some zones will do particularly well out of the massive investment. Saint-Denis Pleyel, for example, will get a giant rail station—a hub on the same scale as Paris St Lazare.

Vector of wealth

The city's reinvention, however, entails much more than enlarged rail infrastructure. During September and October 2017, more than 50 roundtable meetings were held as part of the call for projects to "Invent the Metropolis of Greater Paris". These meetings, chaired by Patrick Ollier, president of Métropole Grand Paris, saw 153 finalist groups present their proposals for the development of 56 sites.

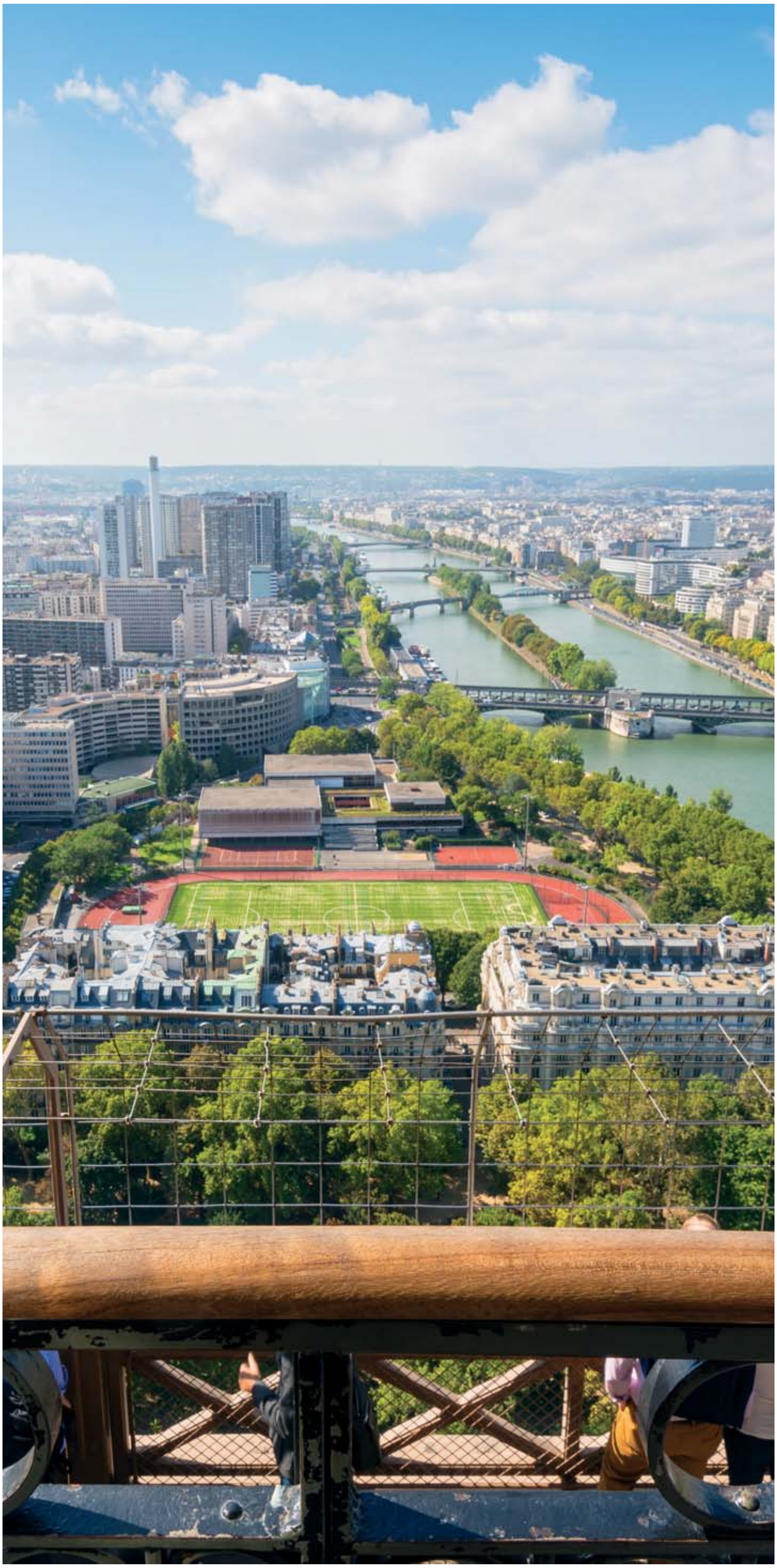
The competition generated a total investment of an estimated €6.4 billion, or one point of GDP for the metropolis, to build 2.6 million square meters of offices, housing, leisure, and public amenities. Following the consultation, La Française won three of the five largest sites: the Pleyel crossing in Saint-Denis, the Ardoines in Vitry-sur-Seine and the Rungis Bridge in Thiais and Orly.

Alongside its cultural and architectural significance, Grand Paris has huge importance from an economic perspective. It aims to streamline and facilitate the daily movements of two million people by creating hubs of activity at the regional level—innovation and research in Saclay, healthcare in Villejuif, aeronautics in Bourget, and TV and cinema in Saint-Denis Pleyel, for example. "These developments will clearly be a vector of wealth when we consider that the GDP per capita is 15 percent higher in the major developed cities," says Xavier. "With Brexit and the Paris 2024 Olympic Games, the project benefits from a buoyant context that could allow Paris to become the European capital."

Ownership for life

In addition to its three key projects, La Française Group wants to help develop the eco-districts that will be created to support the major infrastructure developments. "To do this, we will create an unlisted real estate company in which we will make a €50 million commitment with the objective of generating €1.5 billion in inflows within two years," says Xavier. However, for the Grand Paris project to achieve its full potential, La Française Group believes innovative thinking around the evolving needs of tenants is essential.

Marc Bertrand, CEO of La Française Real Estate Managers (REM), the group's real estate investment arm that is managed by a 140-strong team, of whom 120 are based in France, 15 in Germany and five in the UK, says: "We reckon that the Grand Paris project currently has a glut of office development, particularly around second-string stations. In these zones, we would rather invest in housing developments where demand



remains strong. This rebalancing is necessary, but still tricky for the municipalities for whom house building inevitably entails major investment in public infrastructure with little in the way of additional resources to fund it."

In order to better meet the needs of tenants, La Française suggests proposing the concept of propriété à vie or "ownership for life" whereby residents can become "owners for life" instead of "owners in perpetuity." Inspired by a model in place in the UK, it is an alternative to "ownership in perpetuity" or simple rentals. "The idea is to acquire a property from an institutional investor for use during a very long predefined period," says Xavier.

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Akin to a long-term lease, the property would be held in a real estate investment trust (REIT) and could be returned to the investor at a price that is protected against inflation. For example, say you bought a 50-year lease and had used 10 of those years, the REIT would buy it back at 80 percent plus inflation. The investment vehicle, in return, would typically receive an annual return of 4 percent, akin to returns from offices and higher than the 2.5 percent average on residential property investments. A second proposal is the "partially perpetual loan", which echoes existing systems in Switzerland, Sweden and the Netherlands, whereby the borrower repays the capital over a period of time in line with his or her expected lifespan. "Everyone wants to live in the same place, but scarcity of land means that the prices of real estate for residential properties are not within financial reach for the next generation," says Xavier. "These proposals could really help."

Space optimization

In the office sector, the investment manager has proposed injecting greater flexibility into rental leases so that premises can be converted and transformed to better suit a tenant’s needs for a fixed period of time. The asset manager is witnessing rapid changes in the use of spaces and services within office buildings and is investing in high-tech buildings, green buildings, and new concepts, such as co-working and incubation platforms.

"The panel of the calls for projects were particularly sensitive to our innovative proposals for offices and housing," says Xavier. Connectivity is one big issue. "It is obvious that these days any building that is non-connected—in other words, a building where wi-fi and mobiles do not work—is not going to be let," says Marc. This, he says, is only the tip of the iceberg, with recent buildings featuring highly sophisticated building management systems. He points to a mismatch, however, between the way buildings are constructed and how they are used. "For instance, a consultant might rate the energy consumption of an office building at a very different level from what it actually consumes when occupied. You have to make sure the technology in place remains within the reach of users. If they do not understand the technology, people try to improvise, which generally proves pretty costly in energy terms."

Optimizing space usage is an even greater issue. "Company restaurants are no longer canteens but have become living spaces, used all day long, with creative decor and a convivial atmosphere that better suit the way companies are organizing themselves and working now," continues Marc. "A single space can, therefore, serve multiple uses. This is the biggest change we have seen."

Going beyond this approach of optimizing space usage, La Française is seeing new living spaces appear: a vegetable garden in the courtyard, a music room or a gym on the ground floor. "These new services come with an operating cost and we have found that only significant-sized buildings can absorb these new expenses," says Marc. "Streamlining and developing these services in a way that makes them accessible to smaller buildings is a key issue for managers like us."

Investment diversity

As opportunities abound and inflows rise, today's real investment market is going through an intense process of diversification. Investing across the euro zone does not bring any great change in returns as yields in Europe's major cities are broadly comparable, ranging from around 3.7 percent to 4.5 percent. However, it allows investment managers to take positions in markets at different stages of the economic and rent cycle, which vary considerably from country to country. "The UK, for instance, has entered a declining cycle, Germany is still in a growth phase and in France rents remain low, but growth prospects are clearly improving," says Marc. La Française has around 80 percent of its investments in France with the remaining 20 percent mostly in Germany and the Benelux countries, and to a lesser extent the UK and Ireland.

"Over the last three years, we have used our presence in the German market to diversify the real estate portfolios of several French collective real estate investment vehicles, which have been enthusiastically received by French retail investors," adds Marc. Investors should consider both geographic and sector diversity. An analysis of "metropolization" shows that Lille, Bordeaux, and Nantes are among the French cities outside Paris that have undergone urban renewal and are successfully expanding their economic activities. Conversely, Rouen and Orleans, although only an hour from Paris, have seen some of their economic activity sucked out by the Paris region.

An analysis of towns' development policies, meanwhile, points to Lyon as the model to follow, according to Marc. "Its urban community policy sets it apart in the market, notably as regards business real estate. In terms of dynamism, it is easily the equal of European cities like Milan or Dusseldorf."

In terms of sector diversity, investors have numerous options. "They should keep in mind that it is social and demographic trends that drive demand for buildings," explains Marc. La Française is finding interesting opportunities in student and young worker residences, tourist accommodation, non-medical senior homes for people who are still independent looking for leisure services, and nursing homes for dependent elderly people. "Cash flow is highly visible and very long-term," he says.

Investors from further afield—Asia being a notable example—are becoming increasingly alert to the opportunities in Europe. In 2016, China became the largest cross-border real estate investor, overtaking the United States. In the decade to 2017, its commercial property outflow soared from less than US $1 billion to more than US$20 billion annually.

Sustainability

Just as Grand Paris has at its heart the desire to create a sustainable and innovative metropolis, new sustainability criteria are also priorities for modern-day real estate investors. Demand for reporting on socially responsible investment (SRI) criteria is on the rise, driven by new regulations. Generally, the bigger the investor, the likelier they are to take a mature approach to SRI. "Today, for a northern European investor, it is unthinkable to invest in a non-SRI asset or fund," concludes Marc. "Small investors take a different approach. Not that they are in any way opposed to SRI, but they are waiting for clear proof of the economic case. It is our job to explain the virtuous circle created by renovating buildings to the new standards.

Such renovation means they can be let faster and sometimes for higher rents. Tenant demand for buildings that are compliant with the new standards is also pushing the market forward much faster than legislation alone could have done."

New business model

Against the backdrop of an ever-evolving real estate landscape, traditional real estate asset managers are modifying their business models in order to meet new challenges and take advantage of new opportunities in financing. To remain competitive, they are getting involved in the earlier stages of the value chain by financing development projects, as well as in the latter stages by thinking innovatively about the needs of tenants.

In addition to adapting its business model, La Française Group is modifying its distribution chain to better suit new consumer behavior. In October 2016, it launched Moniwan, the first 100 percent digital real estate investment platform for private individuals. A year later, it has recorded net inflows of more than €15 million for its collective real estate investment vehicle product range.

To the point:

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