Real estate in France

A safe haven investment?

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PERSPECTIVES

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In summary

It is widely recognised that a safe haven investment is one whose value does not fall during an economic or financial crisis. A safe haven investment is therefore a counter-cyclical investment in the sense that it is highly resistant to economic cycles and exhibits lower correlation to more risky asset classes.

Gold is often presented as the safe haven investment of choice. It has served as a store of value since ancient times. Its market price is not directly linked to changes in financial markets or the economic context, but this does not necessarily mean that its value will not fall, as was the case from 2012 to 2016 (figure 7).

Even if real estate is also often presented as a safe haven investment, it is worth investigating the reality of such a proposal. Indeed, real estate is often presented and discussed as a whole in the mainstream media. However, the term covers various asset classes that each follow their own logic and rationale. The current crisis is revealing the risk associated with various assets, and now is therefore an ideal time to discuss this notion.

In this article, we will examine the real estate market from two different perspectives:

A. First, we will analyse direct ownership of a real estate asset. We will note that the French prefer investing in real estate directly, as it is a reassuring asset class with an unrivalled (and even improving) balance between risk and reward over the long term.

B. We will then focus on mechanisms for indirect investment in real estate, such as shares in different types of real estate companies, developers and REITs [1], with a special focus on this last type. These companies (whether listed or not) tend to outperform the market in the long term, but they are more risky than direct ownership of the underlying asset. This usually results from the high levels of debt that these companies often have, as well as the highly specific nature of their assets (housing, shopping centres, offices, warehouses, etc.).

As a conclusion, we will touch upon the impact of the current health crisis on the French real estate market. The market has slowed down considerably, with multiple risks weighing down on both real estate assets and stocks.

Note

1) REIT: Real Estate Investment Trust

1 Investing in bricks and mortar, an unbeatable risk–reward ratio over the past 30 years

a Real estate, an asset class appreciated by investors (and individuals)...

The French are fond of investing in real estate: for example, 65% of them owned their main residence in 2018, compared with 52% in Germany[2]. This proportion grew continuously between 1980 and 2010 and has since remained flat at this level. Further, real estate represents approximately 61% of the wealth of an average French household[3].

Although the price of real estate can vary depending on different parameters (location, interest rate, economic context, demographics, etc.), several reasons can explain the preference of individuals and investors for this class of asset:

- Real estate assets are tangible, physical, material.
- They benefit from (i) a primary use value in the sense that they fulfil certain fundamental needs (for individuals as much as for businesses) and (ii) a high exchange value. These assets can easily be rented or sold, which makes them liquid in a market and therefore easily transferable. This represents a level of security for the owner, who is able to get rid of the asset quickly and relatively easily.
- Real estate lasts over time, with a longer operating cycle and investment horizon than the majority of other assets (long construction and occupation period (minimum 18 months, French law for commercial leases 3, 6, 9 or 12 years), etc.).
- Real estate assets are able to generate stable revenues over time.

For these reasons, the price of real estate does not correlate particularly highly with other asset classes such as shares or bonds. These differences make investing directly in real estate an attractive option when pursuing a strategy to diversify an investment portfolio. But beyond pure diversification purposes, investing directly in real estate in France can help investors to optimise their risk–reward ratio in their portfolios.

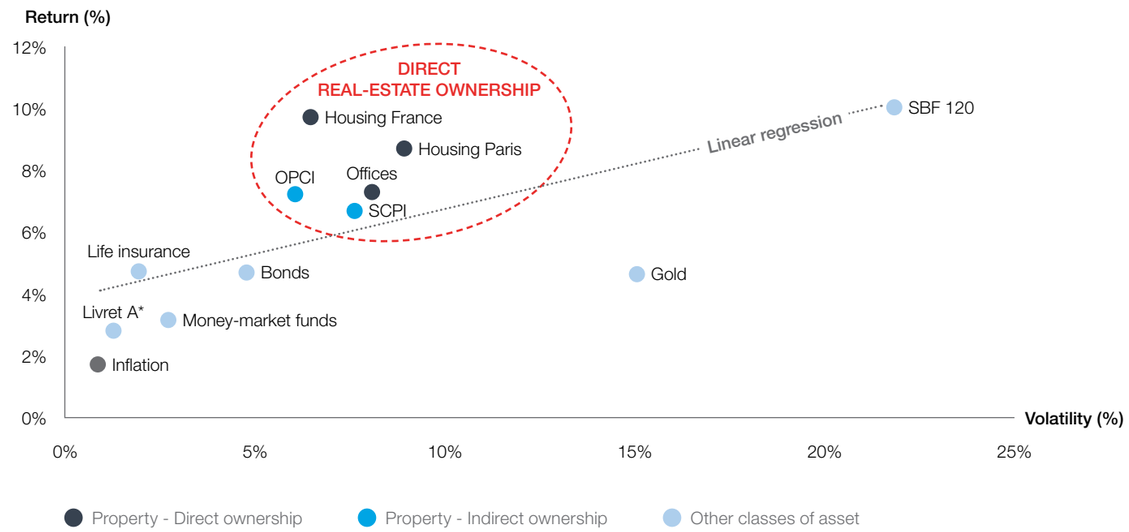
b ... and an unbeatable risk–reward ratio over the past 30 years

The return on a real estate asset can be received in two ways:

- Rent received (or saved for an individual in his or her main residence) from the letting of the asset
- The variation of the value of the real estate over time.

Based on data published by the Institut de l'Epargne Immobilière et Foncière (IEIF), over a period of 30 years, the return on a real estate asset has equalled that of the stock market but with a lower level of volatility (and therefore lower risk)[4].

Figure 1 **Average risk–reward ratio over 30 years (1988–2018) in France for different classes of asset**



Source: IEIF (Institut de l'Epargne Immobilière et Foncière)

Figure 1 note

The return calculation is based on an entry price, an exit price and intermediate flows for unlisted assets and on annual performance with revenues reinvested for listed assets.

**Livret A corresponds to a type of instant savings account.*

If we look at the development of the risk–reward ratio in the shorter term (five years in the figure below), we can see that real estate globally outperforms other classes of asset.

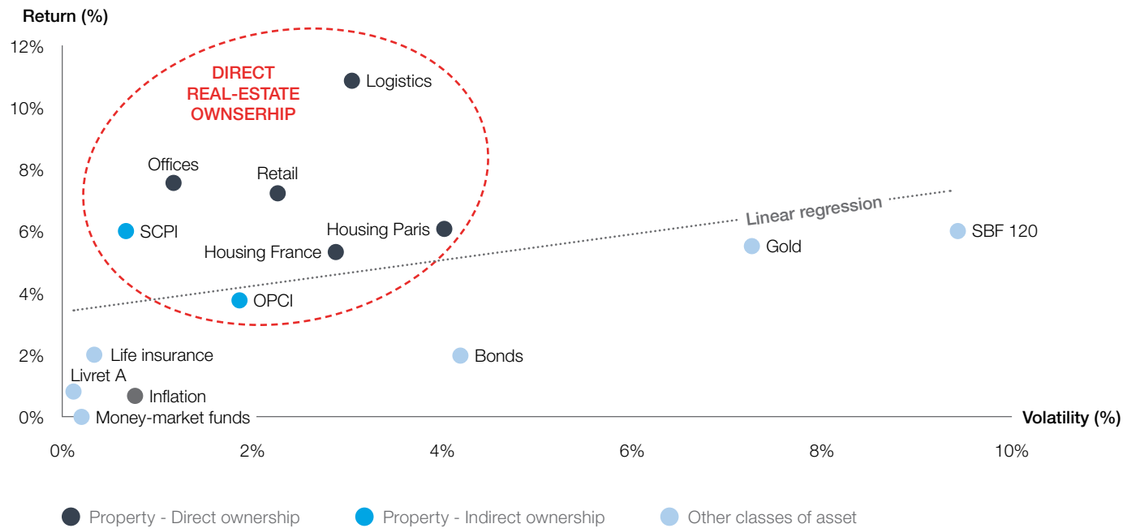
Notes

2) Proportion of real estate owners within the French and German populations 2009–2018, Statista

3) Revenues and wealth of households – 2018 edition, INSEE

4) The volatility formula used by the Institut de l'Epargne Immobilière et Foncière is not shared but it is generally accepted that it is calculated as an annualised standard deviation calculation

Figure 2 **Average risk–reward ratio over five years (2013–2018) in France for different classes of asset**



Source: IEIF (Institut de l'Epargne Immobilière et Foncière)

Over the period 2013–2018, a period of more limited volatility in the stock market, the return on real estate assets remains high for a limited risk. The stability in this performance can be explained by several factors, including:

- The scarcity effect of real estate in certain areas (land availability, lack of new housing construction, etc.);
- The appetite of the French for this asset class;
- Strict financing conditions required by lending banks in France, based on solvability criteria versus real estate value. Such a mechanism limits downward trends in case of economic downturns;
- Recent easier access to credit and a downward trend in interest rates.

The risk–reward ratio of real estate assets is therefore more attractive than that of other classes of asset, no matter their level of risk. It should be noted that unlisted real estate funds (SCPI, OPCI) perform in line with direct ownership. Only gold (which does not generate rent or dividends!) comes close to the return profile of a real estate asset, but it suffers from a more disadvantageous volatility profile due to a significant price sensitivity in terms of different tensions in the economy, movements further amplified by leveraged financial products.

Transaction volumes historically affected by crises but proving resilient

The characteristics of the real estate market have pushed French investors to invest heavily in this asset class.

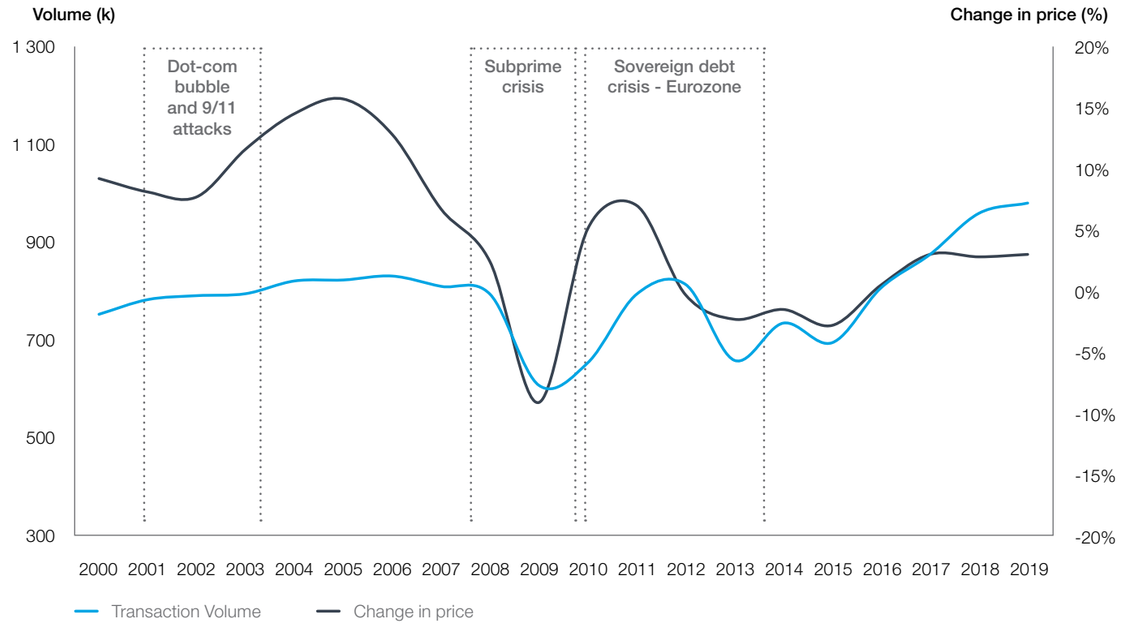
The number of conveyancing transactions for homes in France remained globally constant until the subprime crisis; it even grew between 2001 and 2003 despite the stock market crash following the bursting of the dot-com bubble and the 9/11 attacks in 2001.

The volume of transactions fell by approximately 30% between 2007 and 2008, as access to credit was restricted in this period. This fall in the number of transactions led to a decrease in the average price of real estate in France of 9% between Q1 2008 and Q1 2009.

The real estate market started to recover from 2009, with the massive quantitative easing programmes instigated by central banks and updated conditions for access to credit. Between spring 2009 and summer 2011, real estate prices in France grew by 12% [5], and the cumulative volume of transactions over 12 months returned to its level from before the crisis, all this despite the ongoing eurozone crisis.

This level of transaction volumes continued growing significantly over the

Figure 3 **Number of transactions and year-on-year change in prices of second-hand housing in France from Q1 2000 to Q3 2019**



Source: CGEDD according to DGFiP (MEDOC) and notary databases

Note

5) Notaries / Insee index of second-hand homes

period, after a low point in 2012. This low point mostly derived from a slowdown in investment decisions made by individuals because of the economic uncertainty partially generated by the sovereign debt crisis in the eurozone.

Thus, we can see that over a long period the volume of transactions for residences can sometimes be affected by economic crises, but it tends to recover quickly. In parallel, the value of the underlying assets is resilient in times of crisis, notably because of the reluctance of real estate owners to reduce selling prices.

Direct ownership of real estate can therefore be considered a safe haven investment due to its lower volatility compared with the stock market. Direct ownership's past performance can even be considered as a paradox and a golden era as its return on investment has been equal to (over a 30-year period) or even higher than (over a 5-year period) stocks. Such surprising performance can be explained by several factors, such as falling interest rates or the scarcity effect. In the next part, we will review indirect real estate ownership investment through ownership of REIT shares.

a Two large categories of shares for two different roles: developers and REITs

As a reminder, the real estate industry can be split into two main types of players:

- Developers, who build and then sell properties
- REITs, who invest in and then manage (or outsource management of) properties.

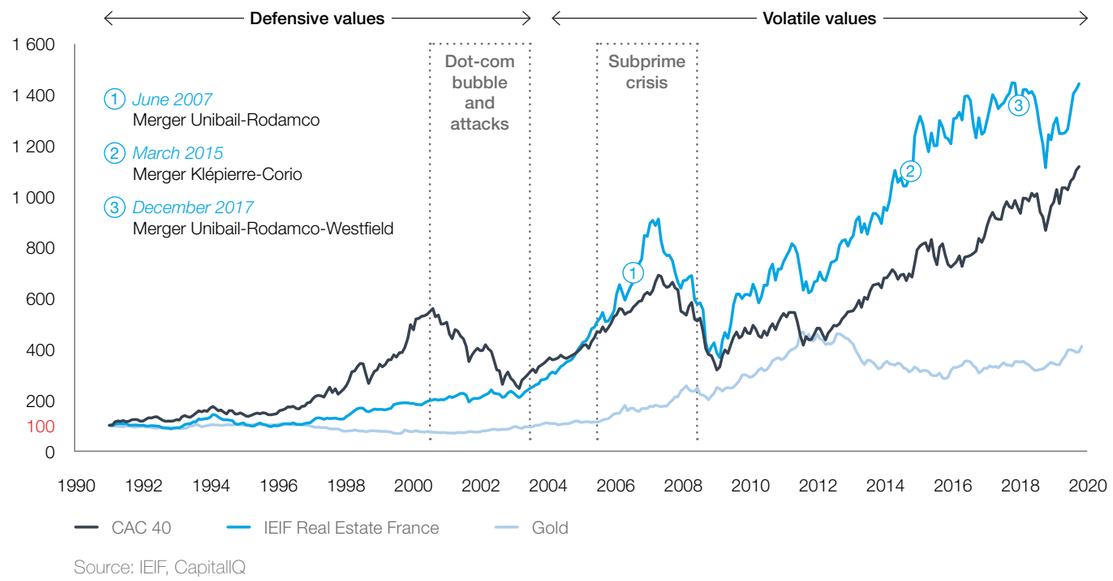
These two categories for the most part comprise listed international players operating in several countries – real estate provides investment opportunities all around the world. The largest market is in the USA, with over 220 listed real estate funds and numerous significant developers. By comparison, Europe has around 30 listed funds.

The IEIF Real Estate France index provides a view of the market performance of real estate players in France, composed of 13 REITs and five real estate developers listed in France (cf. appendices for breakdown). Over the period from 1991 to 2020, companies making up the index developed significantly, with for example several major mergers and acquisitions (Unibail and Rodamco in 2007, then Westfield in 2017, Klépierre and Corio in 2015). Furthermore, several French REITs are amongst the leaders in Europe.

b Real estate stocks: from defensive to volatile values

As shown in the figure below, the IEIF index has outperformed the CAC 40 since the dot-com bubble burst in 2001–2003, with a rapid recovery following the subprime crisis of 2008–2009.

Figure 4 **IEIF Real Estate France index vs CAC 40 until 31 December 2019 (base 100 as at 31/12/1990)**



Source: IEIF, CapitalIQ

Figure 4 note

As REITs distribute a significant level of dividends, the indices have been given with the reinvestment of gross coupons

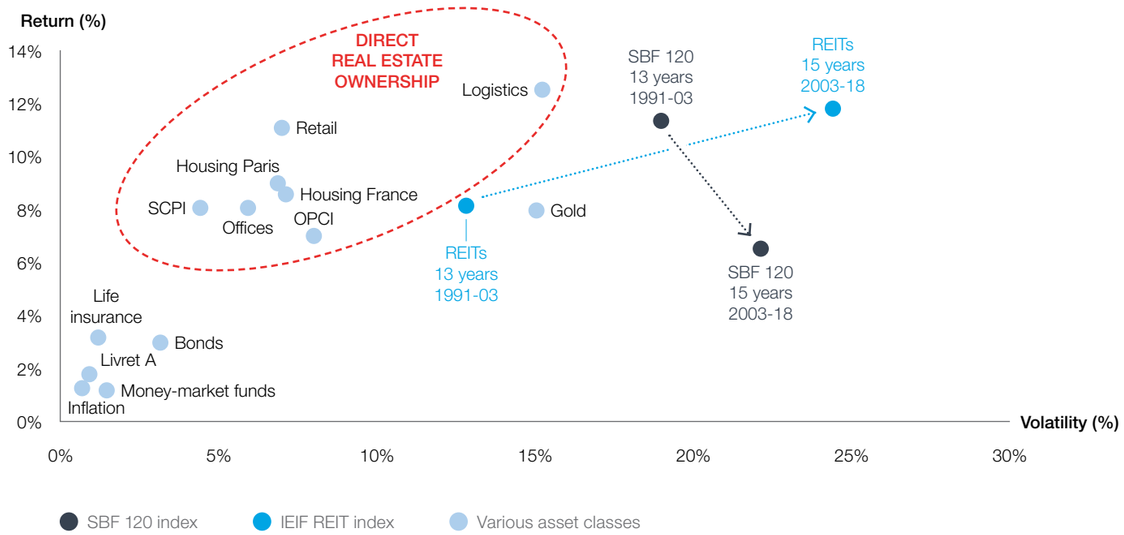
In September 2000, the CAC 40 reached a significant peak of 6,944 points (excluding reinvested dividends), the culmination of a period of strong growth since the middle of the 1990s. The bursting of the dot-com bubble followed, then the 9/11 attacks in 2001, leading to an almost 65% decrease in the value of the CAC 40 in two and half years. During this crisis – and even though the CAC 40 fall was accentuated by the weight of banks in it – REIT share values, in contrast to the CAC 40, continued to climb (even faster than gold). Over this period, investments in listed real-estate companies acted like safe haven investments, with prices uncorrelated to market developments.

Conversely, after the dot-com crisis and the 9/11 attacks, namely in around 2003, REIT market values correlated much more closely with the development of the rest of the market. This change in the behaviour of REIT share values results from a certain number of structural factors detailed below.

Risk–reward ratio of real estate stocks vs direct ownership of real estate assets

The figures below consider the REITs included in the IEIF Real Estate France index, in the analysis of risk–reward presented previously[6].

Figure 5 **Risk–reward ratio over 15 years in France – REITs vs other classes of asset, 2003–2018**



Source: IEIF (Institut de l'Epargne Immobilière et Foncière), Accuracy analysis

Figure 5 note

The periods 1991–2003 and 2003–2018 are presented for the stock exchange index and REITs

Note

6) Real estate developers have been excluded from this analysis because few players have been listed over a long period

As previously observed, between 1991 and 2003, REIT shares constituted low-risk assets, exhibiting for that matter a reward profile below that of the market. Conversely, the period 2003–2018 shows a change in behaviour for these assets, becoming more volatile with a greater reward profile.

Further, we can observe the difference in volatility between the real estate assets (direct ownership of real estate assets) and the shares of the real estate companies. This can mainly be explained by the level of financial leverage of these companies (figure 10).

Several elements can be put forward to explain the shift in the profile of real estate stocks towards greater volatility:

- Growth of financial leverage: REITs saw their debt ratio increase from 0.6 in 2005 to close to 1 from 2018[7].
- Underlying real estate prices grew significantly in the 2000s, thereby increasing the value of REIT portfolios and leading to significant growth of their corresponding share prices.
- The dividend distribution rate grew from 0.6% in 2005 to 6.4% in 2018 (see appendix, page 12)[8].
- A tax incentive scheme (SIIC regime in 2003) was introduced in France creating a structural surplus value in this sector, even if, for several years now, the market net asset values of REITs (mainly based on the gross market values of the underlying assets) have been significantly below their share market value, notably for retail REITs (e-commerce impact).
- New high-performing niches have developed (e.g. logistics with the growth of e-commerce).
- There was a consolidation trend in the market, with several significant mergers as previously mentioned.

The strong performance of the real estate market also pushed numerous institutional players to increase the percentage of their investment in the sector, or even to create their own real estate funds, such as Axa, Amundi and BNP Paribas. However, when it comes to retail, performance has recently been affected by the expansion of e-commerce, further accelerated by the COVID-19 crisis (see below).

Due to several factors (including higher leverage and dividend yields), the profile of REIT stocks has changed: formerly defensive and resilient to economic cycles, they have now become volatile, yield assets.

Notes

7) Ratio between net book value of debt and net book value of equity

8) Ratio of the dividend from year N-1 / share price in year N

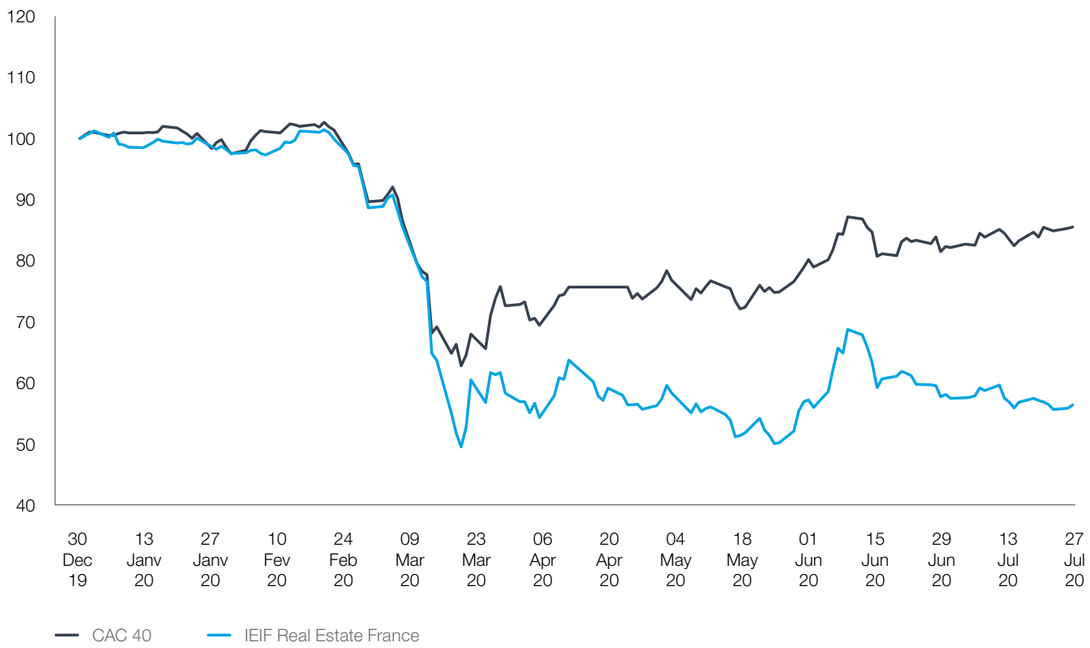
3 The COVID-19 crisis: a leap into the unknown

We have not seen the like of the current crisis since 1929, either in terms of its nature or in terms of its current and future impact on the economy and the markets. Stock markets globally lost almost a third of their value in less than a month and numerous economies shut down as a result of the lockdown of several billion people across the world.

Listed real estate companies have not been spared: the IEIF Real Estate France index has been affected even more than the CAC 40 since the start of the year, as shown in the figure below.

This is notably the consequence of more volatile stocks (as explained previously), in particular the impact of the previously unforeseen closure of shopping centres. It is, however, too soon to conclude on any kind of development in the valuations of REITs and real estate developers.

Figure 6 **IEIF Real Estate France index vs CAC 40, base 100 as at 31/12/2019**



Source: IEIF, CapitalIQ

Two major risks are weighing down on the real estate market (both direct and indirect ownership):

- A restricted availability of credit: as was the case during the subprime crisis, banks may restrict access to credit for a certain period, reducing investors' borrowing capacities or removing them from the credit market altogether.
- Business failures: business failures would lead to an imbalance between supply and demand in the professional real estate market.

As observed in the past and if the conditions for obtaining mortgages are favourable, the safe haven status of direct ownership investment real estate should make it possible for real estate transactions to pick up again and for asset values to remain stable or suffer only a very limited decrease.

However, market players – both REITs and developers – are exposed to far greater risks.

The lingering risk for REITs in the short and medium term relates mostly to rental risk. As their portfolios are largely composed of offices and retail properties, the health of the economy as a whole will have a direct impact on their level of risk.

Almost all retailers had to close for a certain period of time during the lockdown. The recoverability risk and the level of rent during and after the lockdown period is therefore very significant. This is all the more true as rent (and service charges) represent a very high fixed cost for retailers.

We are thus seeing an increase in the number of requests from retailers for the outright cancellation of rent during shutdown periods and the full variability of rent on the basis of revenue for a period to be defined (generally the time it takes to regain the pre-crisis level of activity).

In the longer term, this trend may end up calling into question the standard long-term commercial lease in France, with the aim (for retailers) of making lessors bear more of any potential operating risk.

As for real estate developers, the risks are more limited at this stage and mostly concern delays in construction, the slowdown in the commercialisation of certain assets, and changes to buyers' needs.

Indeed, the massive use of remote working during the lockdown and the proof of its success may well lead the main users of office spaces to rethink their use of – and even their need for – their headquarters and other buildings.

4 Conclusion

Direct ownership of real estate clearly presents the characteristics of a safe haven investment (limited risk, certain return, uncorrelated with economic cycles, etc.); indeed, it has demonstrated this fact historically. Paradoxically, it has also demonstrated historically that it is at least as profitable as stocks for a more advantageous risk profile. We note, however, that these characteristics depend heavily on the development of interest rates and access to credit policies put in place by financial institutions.

Conversely and since approximately 2003, listed developers and REITs have become offensive stocks that outperform and are more volatile than the market. The new risk–reward ratio associated with them can be justified through various parameters: the sometimes high level of leverage of these players, an accommodating dividend distribution policy, the economic performance of the underlying asset and the implementation of tax incentives, notably.

The economic crisis resulting from the COVID-19 health crisis has had a direct impact on the real estate market. In the short term, the hardening of conditions to obtain credit should, in theory, automatically lead to a reduction in transaction volumes, leading to deflationary pressure on prices. In the long term, we are witnessing the calling into question of the use value of certain assets (commercial, office, urban residential real estate, in particular). If this paradigm shift were to become structural, it would be a departure from the long development cycle analysed above and would necessarily result in a decline in financial value.

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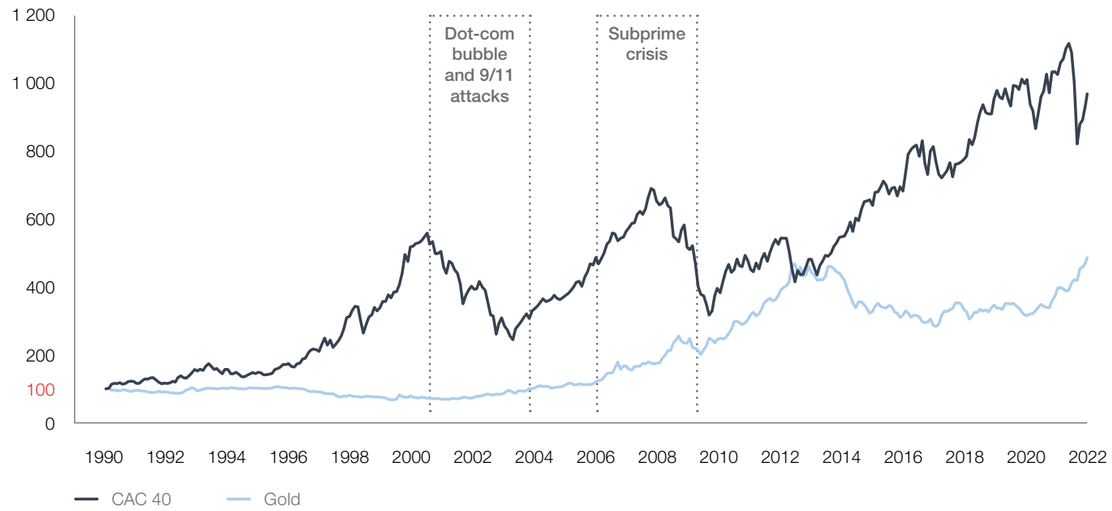
Appendices

Figure 7 **Price of gold vs CAC 40 from 01/01/1980 to 21/07/2020**



Source: CapitalIQ

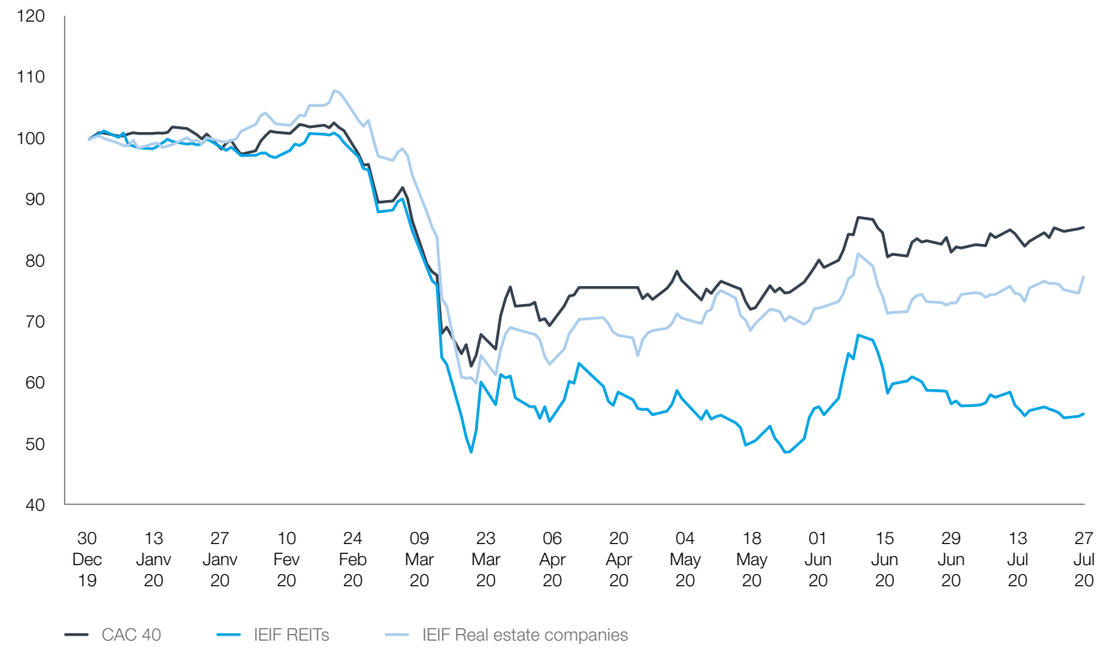
Figure 8 **IEIF Real Estate France index – Weighting as at 21/07/2020**

Altarea Cogedim	5.1 %
Argan	4.6 %
Cbo Territoria	0.3 %
Covivio	15.3 %
Foncière Inéa	0.8 %
Gecina	20.2 %
Icade	10.9 %
Klepierre	12.6 %
Mercialys	1.6 %
Patrimoine & Commerce	0.5 %
Selectirente	0.8 %
Tour Eiffel	1.2 %
Unibail-Rodamco-Westfield	17.4 %
REITs	**92.6 %**

Kaufman & Broad	2.1 %
Les Nouveaux Constructeurs	1.8 %
Maisons France Confort	0.6 %
Nexity	4.0 %
Pierre & Vacances	0.4 %
Real Estate developers	**7.4 %**

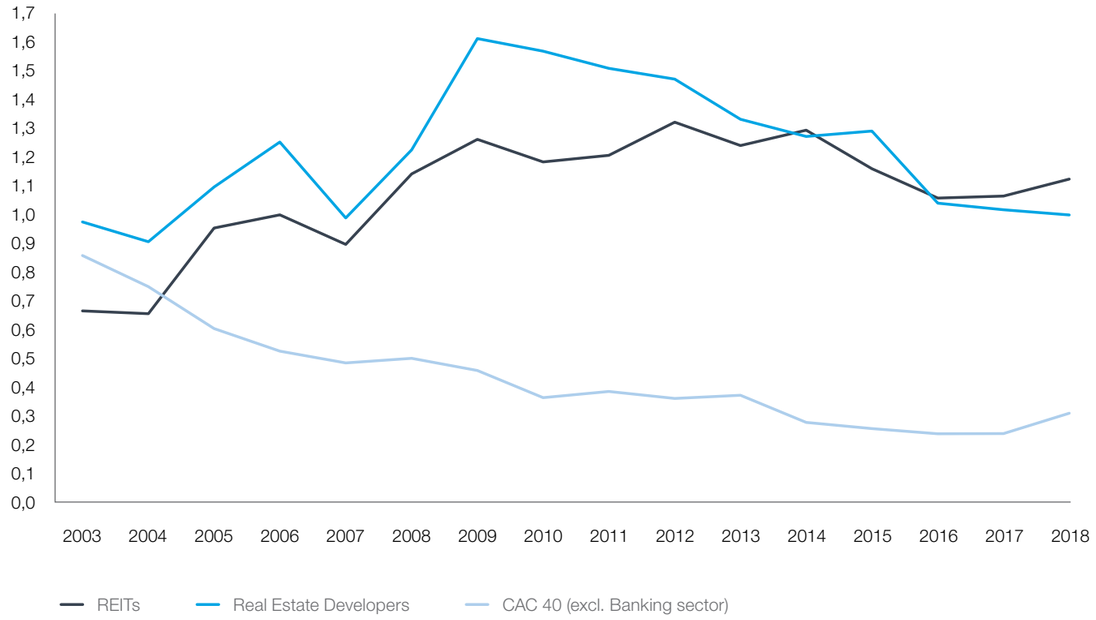
Source: IEIF

Figure 9 **REITs and real estate companies vs CAC 40, base 100 as at 31/12/2019**



Source: IEIF, CapitalIQ

Figure 10 **Ratio of net debt / equity, 2003–2018**



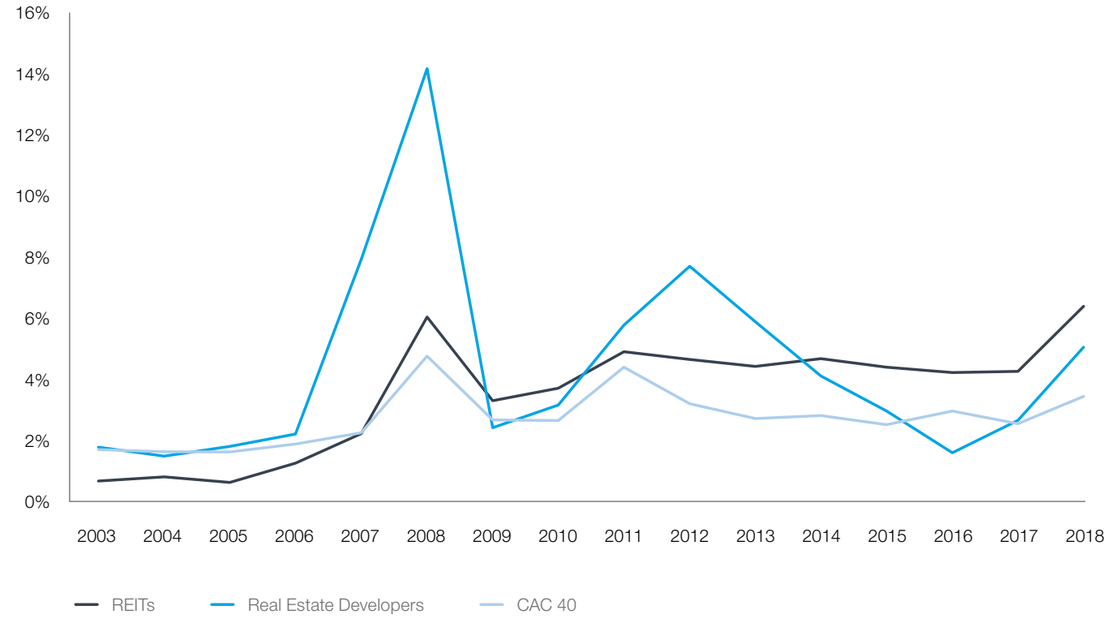
Source: CapitalIQ

Figure 10 notes

Note 1: Companies in the IEIF Real Estate France index used

Note 2: Results based on the average of available data – five REITs and three developers with data in 2003, 12 REITs and five developers in 2018

Figure 11 **Dividend Yield, 2003–2018**



Source: CapitalIQ

Figure 11 notes

Note 1: Companies in the IEIF Real Estate France index used

Note 2: Results based on the average of available data – five REITs and three developers with data in 2003, 12 REITs and five developers in 2018

Method of calculation: dividend Yield = dividend per share / price of a share

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