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French real estate counts the covid cost

Participants in Real Estate Capital's first virtual roundtable predict lenders in France will reprice property debt and reduce leverage as the market copes with the covid-19 crisis. Stuart Watson reports

In three months covid-19 has transformed everything. Not only did *Real Estate Capital*'s 2020 France roundtable take place on the screens of the now almost routine teleconference, but the agenda for the late-April discussion was altered beyond all recognition from what might have been expected had the event taken place in February.

In a coronavirus-free world, after a bumper year for French real estate investment in 2019, the participants would have anticipated reviewing a scalding-hot market, with lenders tightening their margins as they vied to place debt finance with an ever-growing cohort of foreign buyers.

Instead, the four virtual participants find themselves considering at the outset of the debate how deeply the pandemic will damage investor appetite for French real estate.

Olivier Astruc, managing director at private equity firm EQT Real Estate, opens the discussion with a precis of the pre-covid market drivers. "Clearly 2019 was a banner year, with around €40 billion of investment into France, well beyond the historic high," he says. "Around 40 percent of that capital was from abroad, including South Korean investors, alongside the usual investors from Germany, North America and the Middle East. Some of that demand was a side effect of Brexit. Previously, investors from outside Europe would have gone to London first, but they have become more comfortable about the continent and Paris in particular."

Transaction levels to fall

He predicts total transactions will not come close to matching these levels in 2020: "Recent forecasts expect a drop in volume from last year of maybe 30 percent, possibly more. That would take us back to the level last seen in 2017, so we are still talking about a significant volume."

Market indicators point to a more subdued performance this year, agrees Damien Giguet, founder of debt advisory firm Shift Capital. "There will be a demand shock as some investors think twice and adjust their pricing before returning to buying, and that may also create a supply shock – is it better to put a property on the market or wait? Other factors that will influence volumes are the effects of covid on the economy as a whole, on interest rates – which are correlated to spreads – and on the availability of debt financing."

Although Korean investors have played a major role in driving the core and core-plus market, their appetite is likely to be more subdued in the short term, predicts Gwendal Kalkofen, head of real estate finance for Europe at Australian-headquartered asset manager Cromwell Property Group. "We spoke to several French banks who confirmed that the Koreans are not there anymore, partly because they can't travel

Olivier Astruc

Head of France, EQT Real Estate

Astruc is a managing director in the real estate business of global private equity firm EQT, which manages €40 billion of assets, €1.5 billion of which is invested in European real estate. EQT's property holdings are primarily concentrated in the office sector in France, Germany and the Nordics. The firm has also begun to invest in the logistics and residential sectors.

Damien Giguet

Founder, Shift Capital

Giguet founded Paris-based real estate debt advisor Shift Capital in 2012. Over eight years of connecting real estate investors with debt providers, the business has closed 70 deals totalling €1.7 billion. His career has also included stints at JPMorgan as vice-president, structured finance, and at LaSalle Investment Management, where he was head of financings for continental Europe.

Hideki Kurata

Head of France, Greystar

Kurata joined Greystar 18 months ago to lead the global rented residential platform's French operation. Greystar entered France in 2018, and last year acquired local student property manager Acteva, growing its portfolio to 17 assets and around 3,600 beds. The firm is currently focused on expanding its portfolio of housing for students and young professionals in France, principally through development activity.

Gwendal Kalkofen

Head of real estate finance, Europe, Cromwell Property Group

Kalkofen oversees treasury-related activities, including the raising of new debt and management of EMEA loan arrangements, for the Australian-headquartered investment and asset manager. Cromwell owns 23 properties in France, which form part of a €7.5 billion global portfolio of office, logistics and retail assets. The firm maintains 12 European offices.

to see the asset, as well as temporarily losing the benefit of the currency pick-up," he says.

However, Kalkofen expects demand from large domestic institutional investors to take up some of the slack as they seek higher yields to compensate for the low returns available in fixed-income markets: "For insurance companies, real estate yields still look attractive compared with sovereign and investment-grade corporate bonds. In the Paris central business district, up until covid, yields were 2.5 to 3 percent. There might now be some outward movement, but certainly there is high demand from insurance companies buying with all equity."

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DAMIEN GIGUET
Shift Capital

"Loan distribution is becoming increasingly difficult and that has made underwriting more challenging for banks"

GWENDAL KALKOFEN
Cromwell Property Group

Core strength

That trend is likely to underpin core markets, suggests Astruc. "The good thing in France is that you have deep, stable local capital that will look to invest, and will allocate to prime properties because it can't find yield in other places. I expect we will see a higher proportion of core deals taking place in 2020 with that end of the market staying active. We should also see less value-add and less international capital being invested in 2020."

Hideki Kurata, head of France at residential specialist Greystar, expects the rented residential sector to prove comparatively resilient because of the lack of existing supply and low levels of development activity in what is still a nascent market: "We may not see more residential investment activity in absolute terms, but we will see more in relative terms. I am convinced that the proportion of residential and residential-like deals is going to be higher in the overall French deal volume for 2020 because of its de-correlation from the direct impact of a fall in GDP."

Giguet predicts real estate lenders, like equity investors, will retrench to more conservative transactions over the next 12 to 18 months, just as they did after the global financial crisis.

"Right now, most lenders are not available for new financing because they are managing all their waivers with clients, but soon they will be in a position to lend again," he says. "They are saying that maybe they will have less capital to lend because their equity will be negatively impacted by the damage to the economy and by the rate of default on corporate loans.

"Liquidity will decrease and the cost of capital will increase. We anticipate less leverage, higher priced loans and positioning on less risky assets. The core-plus deals of 2019 will become the value-add deals of 2020."

Kalkofen agrees that borrowing costs will remain elevated while the pandemic lasts. "At the start of the pandemic, credit default swaps of banks rose sharply by 50 to 100 basis points on average," he says. "While this indicator is not a true reflection of the banks' funding cost increase, it provides guidance with respect to banks' expected liquidity costs. Since mid-April, credit default swaps from banks have

stabilised or reduced, but remain high compared with pre-covid-19 times."

He expects French lenders to come under growing pressure to increase net margins in order to compensate for the zero interest loans they are required to provide under government-backed funding schemes: "To meet their return-on-equity hurdles, lenders will need to make up for the loss in revenues at some point, and these additional revenue sources may well be the commercial real estate market."

Giguet says that because the lending market is taking time to digest the altered situation, borrowers have not yet seen a repricing of debt: "Most banks, even if they are pretending they will look at new deals, have put the file on their desk and are waiting for the end of lockdown." However, he adds that lenders are largely adhering to the rates agreed on loans arranged before the pandemic hit.

"Due to pricing uncertainty, loan distribution is becoming increasingly difficult," says Kalkofen. "And that has made underwriting more challenging for banks. This will inevitably lead to a return of the club deal market that we have traditionally seen in France, at least for the time being. This is not France-specific, but at present and probably for the foreseeable future the CMBS and syndication market will remain subdued."

He adds that ambiguity over the extent of the inevitable decrease in asset values is limiting the amount of leverage lenders are willing to offer: "Lenders are willing to accept 50 to 55 percent loan-to-value with the potential to upsize if there is a valuation commissioned shortly thereafter. Large-scale acquisitions will be more concentrated on all-equity or very lowly geared transactions."

Sourcing finance for property outside the mainstream sectors, such as private rented sector housing, will constitute a particular challenge in the post-coronavirus world, suggests Kurata. "The market is very immature in France in terms of lending against residential asset classes," he says. "So it is going to be a tricky exercise for lenders to get comfortable with the sector at the same time as the risk profile of the overall real estate asset class is changing. Those that were comfortable

Liquidity, social protections, infrastructure and a diverse economy

The roundtable participants identify France's USP to investors in the post-covid-19 market

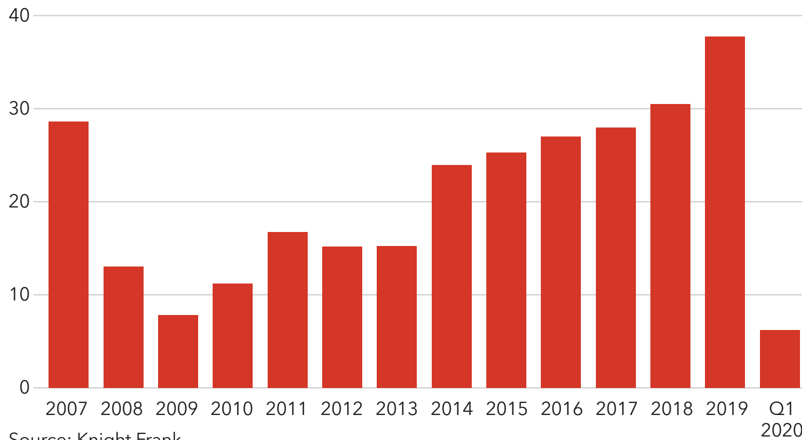
Kurata: One of the things that will get equity and debt investors comfortable again is that France is one of the most liquid markets in the world. In the worst-case scenario it may go through a significant price adjustment, but they know it will rebound, as it has after past crises. We also have the benefit in Europe generally of having social systems that mean that your end resident will be able to afford their rent, which means that the shock to the consumer may be less than we see in the Americas and other countries generally.

Astruc: France is one of the six richest countries globally, and Paris is one of the pre-eminent cities in the world: a global hub with a mature market and a growing population. Like London, and the key German cities, Paris is one of the places where you want to invest in the next stage of the cycle. This is where you will find liquidity, occupier demand, and the beginning of the recovery.

Kalkofen: Ongoing infrastructure investments by the French government, in the Greater Paris region but also connecting key secondary cities in France with the capital, offer enormous opportunities for investment opportunities from core to value-add. Furthermore, liquidity, whether it be on the equity or the debt side, has become so diverse that it will probably be one of the first countries, besides Germany, out of the blocks after the crisis.

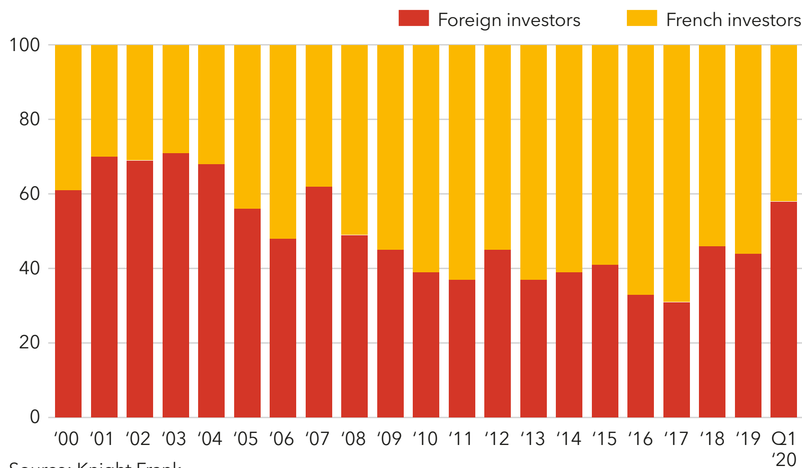
Giguet: There is a very diverse range of business in France, especially in the Paris region, which helps to spread the economic risk. Another advantage from a lender perspective are all the social buffers. That might appear heresy from the UK or US perspective, but even if they make it more difficult to accelerate again afterward, a significant public sector and support for the unemployed help to maintain demand in the case of a big crisis.

French real estate investment volumes (€bn)



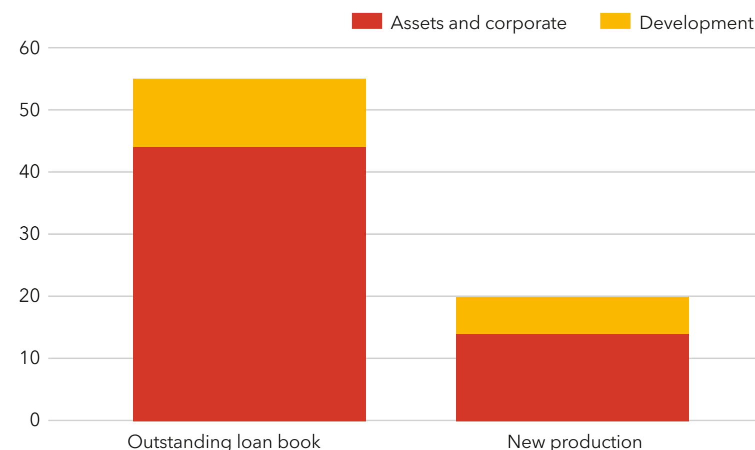
Source: Knight Frank

Investment volumes in France, by origin of investor (%)



Source: Knight Frank

New and outstanding French CRE loans, 2018 (€bn)



Sources: Most recent annual lending data from IEIF and PwC's December 2019 French real estate debt report

before covid are saying that they need to see where asset pricing lands before they can say where they will land, both from a pricing and leverage perspective."

Debt fund dilemma

France's real estate lending market has historically been dominated by the country's major banks. Nonetheless, Giguet observes, as has been the case in the rest of Europe, the diversity of the lending market has broadened in recent years, with increased activity from German Pfandbrief lenders, insurance companies originating loans, and debt funds. Changes in legislation in 2018 enabled non-bank lenders to directly originate loans, rather than just participate in syndicated transactions.

Giguet offers the caveat that French debt funds, which have mostly offered senior debt, have found it difficult to gain a substantial foothold because of competitive pricing from the banks. Meanwhile overseas non-bank debt providers, typically from the UK, have struggled to achieve the high returns they need to match their cost of capital while accepting the added risk posed by

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> **EQT Real Estate**

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> **HIDEKI KURATA**
> **Greystar**

borrower-friendly French loan security regulations.

Will the current crisis, which is likely to make banks more risk-averse and bank lending more expensive, further open the door to alternative lenders?

"This could be a good opportunity for them to cross the channel and increase their market share if they can achieve the pricing they want," says Giguet. "Bank lenders are relying on capital markets, so they have seen a 25 to 60 basis point increase in liquidity costs. Our discussions with alternative lenders make us believe that they will remain here, and they have a lot of liquidity to provide to this market, but they are in an observing position because they do not know how the market will reprice. We expect them to be back in the market again from September."

Kurata notes those private debt funds that have supplied finance to the residential sector are taking a step back from lending for the time being: "They have been the first ones to really hit the pause button for our asset class, which is interesting because they were probably the ones who were most comfortable at a relatively high margin compared with local bank lenders."

Kalkofen adds: "The debt market up until a month and a half ago was certainly very buoyant and is becoming increasingly diverse following legislative changes that allowed a wider lender base to access the debt market. We have seen a more competitive debt market than ever in France, and that has certainly led to an influx of investors."

However, he expects debt funds will still struggle to deploy capital unless managers are willing to lend at higher LTV ratios or against transitional or non-prime assets in order to hit their target return hurdles. "Before covid, we witnessed loan pricing for fully speculative office schemes at below 2 percent in central Paris," he says. "In London, pricing for the same strategy is 2 to 3 percent."

Drivers of occupancy

As the discussion draws to a close the participants consider the medium-term implications of the pandemic for French real estate investment and lending. Which sectors will suffer, and which emerge relatively unscathed? Are operational assets now considered more vulnerable? Will distressed buying opportunities emerge?

"When EQT invests in real estate, we invest in the space people use, which has been totally turned upside down with the recent lockdowns," says Astruc. "But obviously these are exceptional and hopefully short-lived times, so the question for all of us is how we look through that crisis to form convictions for our investments.

"We approach each market by looking at supply, demand and weight of capital. We are lucky in France that supply is reasonably low getting into this crisis. Capital availability will decrease in the short term but will remain, as there is a sustained structural need for reliable yield, which real estate can provide. On the occupier side, we see asset classes with long-term growing demand and an increasing emphasis on social and environmental factors. Despite the current market reversal, we anticipate interesting investments at the intersection of these positive trends."

The operational nature of assets will be less important in determining their resilience than will the drivers of occupancy, argues Kurata. "The driver of occupancy in hotels is travel, so if you stop travel you stop that occupancy," he says. "In residential, it is a mix of being in the right place to work and live and affordability, so in times of recession you may want to focus on more cost-effective housing.

"If you have an efficient operational engine you probably face this type of crisis better than others. We have an office in Shanghai so we got somewhat ready in February by equipping our residences in France with masks, gloves and partitions, which helped ensure that occupancy rates stayed high."

The participants agree that some sectors, notably hotels in the short term and retail in the longer term, will take a considerable hit. However, Giguet predicts that fire sales will be rare. "We could see some situations – which have been financed with whole loans or mezzanine debt on poor quality assets or very risky plays – showing some distress," he says. "But French banks, institutions and insurers tend to push negative news under the carpet and cut a finger rather than an arm while they wait for better times. It is what they did in 2009 and there is no reason it will be different now." ■