All that glitters is not gold

New investors are pushing prime European real estate to unsustainable levels

Adrian Benedict
Investment Director, Real Estate

Grethe Schepers
Fidelity Editorial

European prime real estate is the darling of the markets, but it can't last. New buyers are pushing yields down to levels that are at or below the cost of capital for traditional investors, and which do not offer an acceptable spread over safer bond investments.

It's often said the market can stay irrational longer than you can stay solvent. It is not possible to say when this unsustainable trend will end, but when there are no more top-price buyers to sell to, European prime real estate will be in for a rude awakening.

Mind the cycle

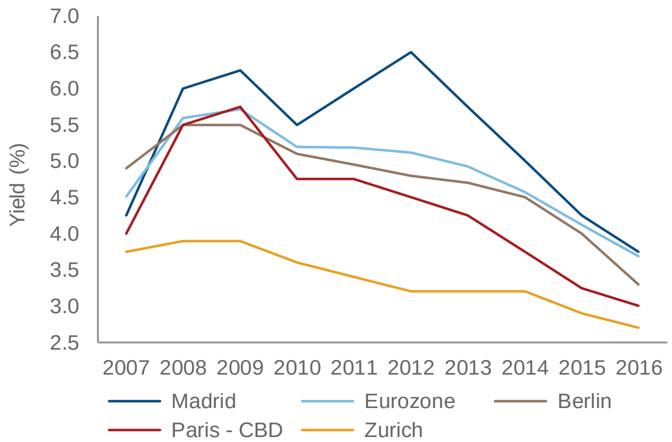
In real estate, unlike in other asset classes, flow analysis can predict market cycles with a high degree of certainty.

In recent years, the sheer volume of capital looking for returns beyond traditional asset classes has dominated the story, raising prices particularly in prime real estate. As returns elsewhere decline, such inflows lead to market booms that typically last two to three years.

Booms turn into crashes, with turmoil typically lasting 12-18 months in the UK, for example. New ownership then sets the scene for a recovery when the market gradually returns to 'normal'.

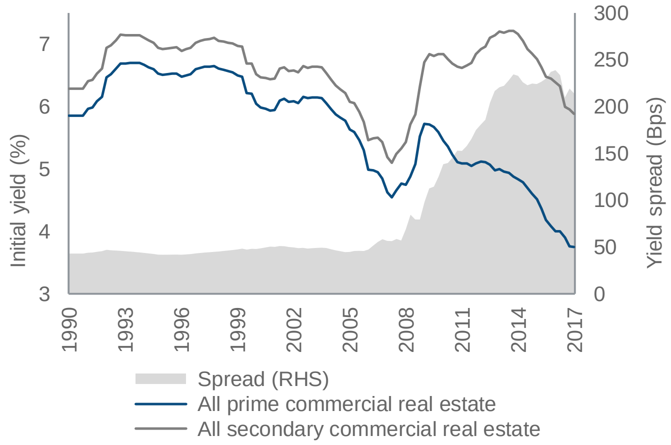
But the current boom in European prime real estate has already lasted five years, as investors chasing yield have bought European commercial real estate assets in unprecedented volumes. Demand for high-quality, prime-grade property has compressed yields to below 4%. Prime properties in Paris's central business district are now changing hands at a yield of less than 3% - something inconceivable not so long ago. (Chart 1.)

Chart 1: Prime yields are now below 2007 levels
Prime yields have collapsed across prime commercial real estate markets, but especially in France



Data for Q4 of each year. Source: Jones Lang LaSalle, Fidelity International, May 2017

Chart 2: A tale of two markets
Prime European real estate has pulled away from the rest of the market



Source: Fidelity International, CBRE, January 2017

As a result, the gap in yield between non-prime and prime European real estate assets has soared. It is now four times its normal size - a level that is not sustainable in the longer term. (Chart 2.) Although prime yields are still well above government bond yields, real estate assets are different: they carry capital risk and can become 'obsolete' over time as their usefulness, desirability or utility decline.

For traditional international real estate investors, yields at these levels are too close to their cost of capital and are no longer attractive. Moreover, we do not expect further strong capital growth in the market, which would otherwise compensate for low yields. It makes sense for these investors to sell up and realise the capital gains they have made in recent years in prime assets, and diversify into other real estate sectors.

A new generation of investors

So if international real estate investors are turning away, who are the buyers willing to accept such low returns for prime European commercial real estate?

Fidelity analysis of the data shows they are a very distinct set of investors, with very different constraints to the mainstream market. These investors have a significantly lower cost of capital than those already in the market, and are therefore able to pay higher prices and accept considerably lower yields.

Key among them are life assurance companies and retail funds, especially in France, which represent retail investors who are shifting their allocations to generate more yield than is available in other products.

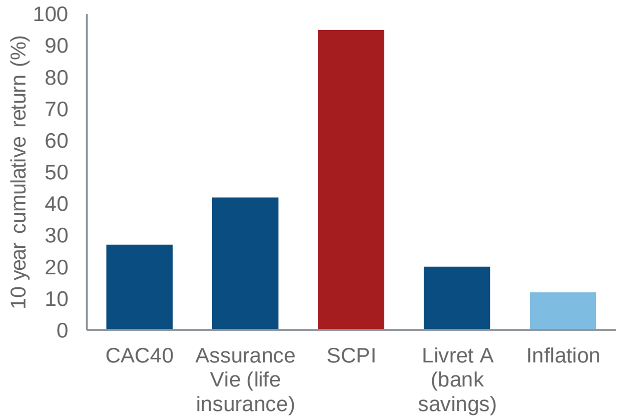
The new alternative: Retail property vehicles

French savers generally opt for life insurance products called *fonds en euros*, which come with multiple tax benefits and capital guarantees. But as returns on these continue to slide, French savers are increasingly turning to real estate investment products, either bought directly, or in a life insurance wrapper with all the ensuing tax benefits.

As a result, there has been a surge in interest for a collective investment vehicle called *Société Civile de Placement Immobiler* (SCPI).

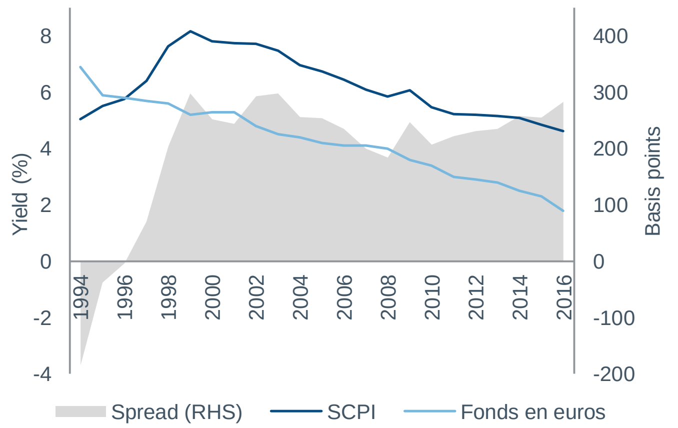
SCPIs come in many variations; they invest in different sectors with varying occupation rates and other characteristics, both in France and more recently abroad, have different stated returns, charge different subscription rates, and may or may not be eligible for inclusion in a life insurance policy. What sets them apart is that their average returns have been substantially higher than those of bank savings, *fonds en euros* or the equity market. (Chart 3).

Chart 3: SCPI returns - too good to be true?
Ten year cumulative returns for typical French investment options



Total return for CAC40. Source: Institut de l'Epargne Immobiliere & Fonciere (IEIF), Fédération Française de l'Assurance, End of April 2017

Chart 4: French savers are forced to shop around for yield
Average returns for traditional *fonds en euros* and SCPI property funds



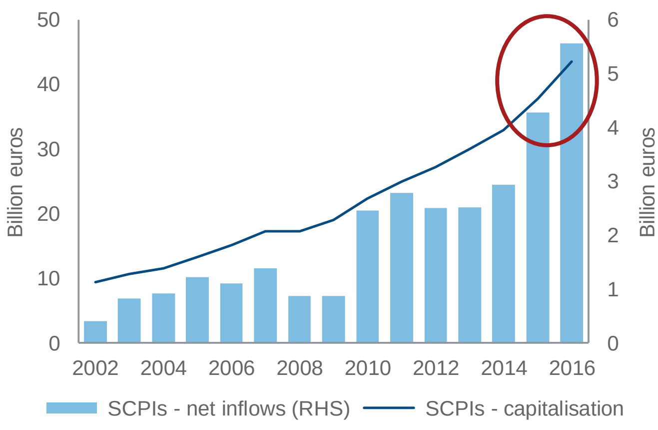
The spread is the difference between the SCPI yield and yield on the *fonds en euros*, in basis points. Source: Institut de l'Epargne Immobiliere & Fonciere (IEIF), Fédération Française de l'Assurance, Fidelity International, May 2017

As long as the (promised) yield on alternative products like SCPIs exceeds those of the traditional bond-based *fonds en euros* - while offering similar tax benefits - investors are likely to switch. Given how low bond yields now are, even without tax benefits property funds are looking a lot more attractive. (Chart 4).

This has led to some staggering inflows. At the end of 2016, France's SCPIs had a market capitalisation of €43.5 billion. Over the year, their capital increased by €5.6 billion with inflows almost a third higher than the year before.[1] (Chart 5).

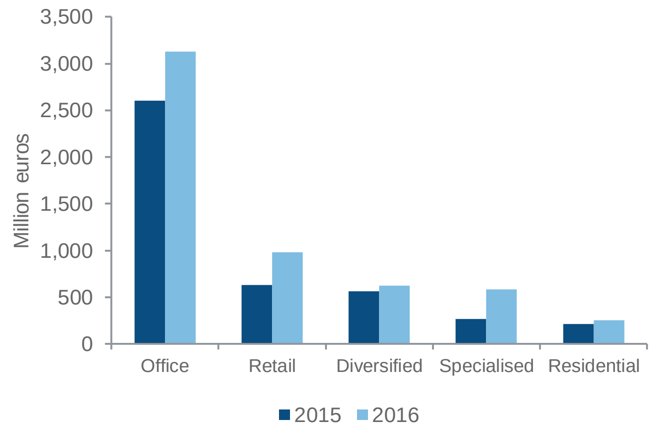
Almost all of this (96%) is invested in commercial real estate, a market that is also heavily pursued by family offices and institutional clients. (Chart 6).

Chart 5: SCPI inflows are growing fast
Assets and inflows for French SCPI property funds



Source: Association Française des Sociétés de Placement Immobilier, May 2017

Chart 6: Office real estate is most popular
Net inflows per type of SCPI



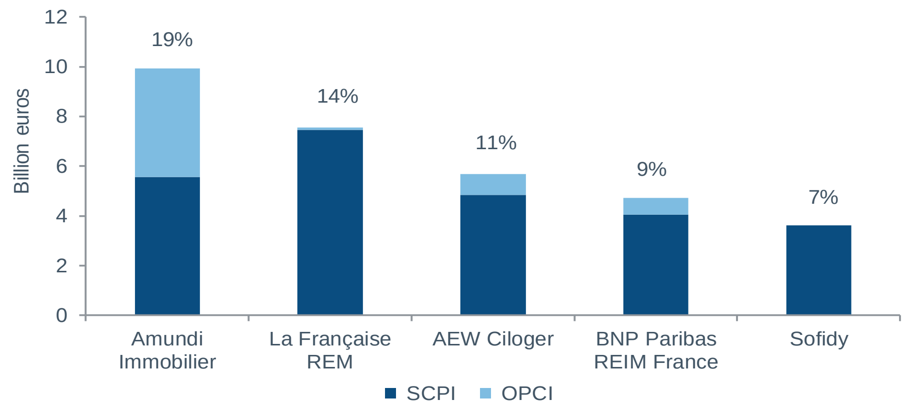
Source: Institut de l'Epargne Immobiliere & Fonciere (IEIF), April 2017

Two managers, Primonial REIM and Amundi Immobilier, pulled in almost a billion euros each in 2016 - equivalent to roughly a third of all inflows - while the next three saw assets rise by about half a billion each.[2] These are remarkable inflows for property fund managers.

All this cash flowing in raises the question of whether there is enough real estate to absorb it. If demand for real estate financing is not growing as fast, it is likely that the funds' returns will be diluted.

Moreover, the same assets are being chased by another real estate vehicle in France - open-ended funds called *Organisme de Placement Collectif dans l'Immobilier* (OPCI). Despite making up a smaller share of the overall market, OPCIs aimed at retail investors grew an astonishing 92% last year to €8.72 billion.

Chart 7: The top five managers account for 60% of the market
Largest French property fund managers in 2016



Percentages indicate total market share (SCPI and retail OPCI combined). Source: Institut de l'Epargne Immobiliere & Fonciere (IEIF), Fidelity International, April 2017

Together, SCPIs and non-institutional OPCIs now account for more than €50 billion in real estate investments, raising worries about a bubble - and if this is the case, what happens when it bursts. (Chart 7).

Cause for concern

Unprecedented inflows have forced the large French life insurers to look around, in France and elsewhere, for attractive returns with added safety benefits.

Not surprisingly, they are now some of the most active investors in prime Eurozone commercial property, where price returns are looking positive but the risks appear contained. (Real estate outside the eurozone, including in the UK, is less attractive in comparison, as currency hedging eats into returns.)

And as bond yields remain low, the appetite for property investment among savers continues to grow. However, these are investors who have experienced decades of relatively safe investment products with attractive, tax-free, guaranteed yields.

It is fair to question whether they will bring the appropriate level of scrutiny to their real estate investments. In fact, the last time the SCPI market suffered a severe crisis was in the mid-1990s, now a fading memory or missed altogether by younger investors.

Another concern arises from the fact that, despite the name, French life insurance products are quite liquid investment products. The tax benefits require multi-year holding periods but they do not normally span decades. Life insurance companies offering these products need sufficient liquidity to handle withdrawals.

Bond markets offer this liquidity, but real estate markets do not, which is a significant source of risk for these firms (and the reason not all SCPIs are accepted in life insurance wrappers and why extra charges apply). When the real estate crisis hit in the 1990s, several life insurers paid a heavy price for their involvement in the SCPI market and one even went bankrupt - the only bankruptcy in the sector since the second World War.

It can’t last

Where does this leave us? We are concerned by conditions at the prime end of the real estate market which could presage trouble ahead. For years, prime commercial real estate in the eurozone was seen as more stable than other major centres in the US and UK. This was reinforced by the financial crisis of 2007/8 where prime continental markets like Paris, Munich and Hamburg saw less capital volatility than London.

Small investors who are hungry for yield are piling in to property funds, displacing large international investors, pushing up prices and depressing yields to unsustainable levels that no longer compensate for the capital risk involved. Yet the alternative for French savers is so poor, that these property funds can operate with historically low costs of capital.

This cannot be sustained for much longer. The turning point will come when savers see their returns eroded, with falling yields, sky-high prices and limited potential for further capital gains.

Once enough savers decide to withdraw their money, property funds could struggle to exit positions and cash in on the capital gains they were relying on. Yet savers have bought these products believing they can be exited flexibly when required. Their demands for liquidity could easily collide with a reality of forced sales and collapsing returns, or even investor lock-ins, when the market turns.

We do not think the market has reached this level yet, and, unlike previous cycles, this new investment is not leveraged, which is encouraging. But we are increasingly cautious; it has all the hallmarks of a bubble which buyers enter at their own risk.

So what can investors do?

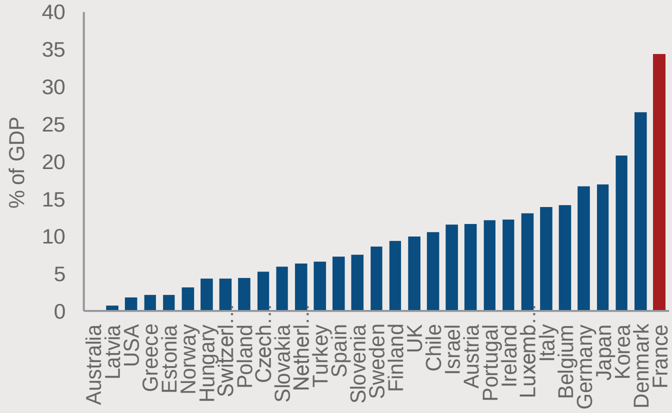
If the bad news is that prime real estate markets are becoming alarmingly detached from the rest of the market, the good news is that prime property is a relatively small proportion of the overall market.

This is therefore the time to ensure you are not over-exposed to prime property, and to seek out non-prime investment within the eurozone or elsewhere which can still command a decent yield - essentially, to avoid investments which are being driven by this wave of investors with such a low cost of capital, representing savers who may not understand the market well enough.

A fondness for life insurance

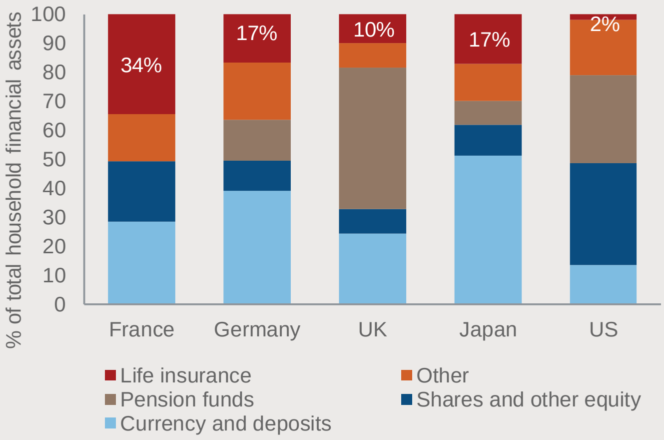
French savers' traditional products of choice are life insurance contracts provided by life insurance companies and sold through local bank branches. The name is misleading: these are multi-year investment wrappers with various tax benefits. Unlike other countries, France imposes no limits on how much individuals can invest in life insurance products … and it shows. (Chart 8).

Chart 8: French savers just love life insurance
Net equity of households in life insurance reserves, as a % of GDP



Measured in US dollar per capita at current PPP, as a percentage of total household financial assets. Source: OECD (2017), Household financial assets (indicator). doi: 10.1787/7519b9dc-en. 25 May 2017

Chart 9: Investment preferences differ markedly
French investors prefer safe life insurance at the cost of equity investments



Household financial assets, measured in US dollar per capita at current PPPs. Percentages indicate share of life insurance in total. Source: OECD (2017), Household financial assets (indicator). doi: 10.1787/7519b9dc-en., Fidelity International, 25 May 2017

Who wouldn't choose *fonds en euros*?

The bulk of these life insurance contracts are '*fonds en euros*', mostly bond-based savings contracts that offer both income tax and inheritance tax benefits and guarantee the invested capital.

When marginal tax rates are high - as they are in France - a few percentage points in return can easily be worth double. And when the returns are guaranteed up front (they are) and life insurance companies protect the invested capital (they do), it is obvious why French savers have for many years loved these products, shunning equity investment. (Chart 9).

Plunging returns are changing the game

Over time, the market for *fonds en euros* has grown into one of the largest savings markets in Europe, with a staggering €1.3 trillion in assets in 2016. In total, *fonds en euros* account for 81% of the life insurance market in France, with the remainder invested in more traditional unit trusts wrappers that lack capital or return guarantees but allow for exposure to equities, commodities, and other asset classes in addition to bonds.[3]

As recently as 2008, these bond-based *fonds en euros* were still yielding 4% - a highly attractive return for top-rate tax payers. But the income on these bond wrappers has fallen to below 2%. As a result, savers have started to look at higher-yielding alternative products, especially as inflation starts to drift higher.

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[1] Fédération Française de l'Assurance, Bilan de l'année 2016 et perspectives 2017

[2] Source: Institut de l'Epargne Immobiliere & Fonciere (IEIF), April 2017

[3] Fédération Française de l'Assurance, Bilan de l'année 2016 et perspectives 2017