INSIGHTS

REAL ESTATE

# FRENCH SUSTAINABILITY NICHE PROVIDES LOW CORRELATION WITH MARGIN PROTECTION


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Spring 2023

**As traditional asset classes struggle for direction in an environment where daily data releases and shifting sentiment set the tone, we must look for return potential beyond the obvious – perhaps even where we least expect it.**

In an environment of rising interest rates and elevated inflation, your mind might not jump straight to real estate. But the asset class is not homogenous, and while some segments such as office buildings have been negatively impacted by macro headwinds, others are a hive of activity, propelled by a new set of environmental and socioeconomic catalysts.

Our real estate analysis takes us to France, where the regulatory environment has created a unique investment opportunity centred around financing urgent city restructuring, that combines an attractive potential return profile, a strong sustainability focus, and natural portfolio diversification due to the sector's low correlation with equity and bond markets.

## FRANCE'S COMMITMENT TO SUSTAINABLE CITIES

France's regional cities are growing fast. While Paris is the icon with some 2.1 million residents, the populations of Marseille, Toulouse, Nice and Lyon, to name a few, are all expanding, highlighting the trend observed across Europe of increasing household numbers[1]. France alone has absorbed 1.5 million new households since 2010[2], with local authorities under increasing pressure to provide more housing. In turn, property developers face huge penalties for delivering projects that do not provide sufficient social units.

Building levels must accelerate to address the problem, creating increasing demand for developer financing.

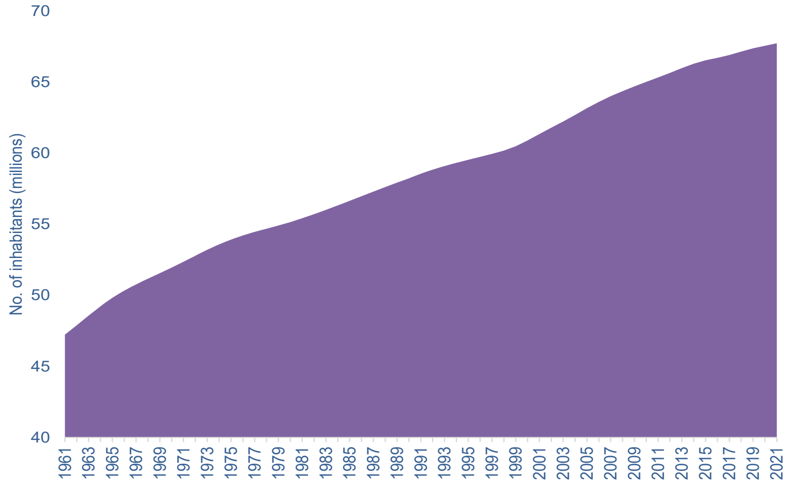
FOR PROFESSIONAL INVESTORS ONLY

[1&2] Global Data, October 2022

Around 81% of France's inhabitants live in the country's larger cities. This growing trend of urbanisation is increasing by 0.6% annually

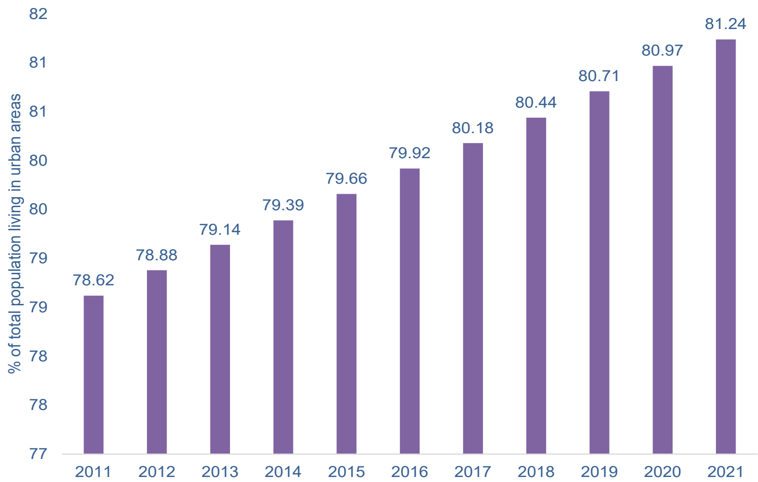
World Bank, March 2023

## CHART 1: POPULATION GROWTH IN FRANCE




**Source**/ World Data, 2023

## CHART 2: INCREASING URBANISATION IN FRANCE




**Source**/ World Bank, March 2023

But rapid city expansion comes at a heavy environmental cost. Agricultural and forest lands are swallowed up, degrading biodiversity, increasing flooding risks and exacerbating global warming through the release of soil-sequestered $CO_2$.

**Instead of continuing to expand outwards, France has written into law that its major cities must increase their density, with land plots and existing buildings being restructured to ensure they can absorb growing populations.**

**As cities become denser, they must also become more energy efficient;** the existing French building stock currently accounts for 43% of national energy consumption[3].



[3] International Energy Agency

If nothing is done, the equivalent of the surface area of Luxembourg will be covered in concrete and asphalt by 2023

France Stratégie think tank

## REGULATION SUPPORTING FRANCE'S SHIFT TOWARDS SUSTAINABLE CITIES

- **Decret Tertiaire**, published in 2019, sets out obligations for the owners of commercial buildings to launch restructuring programmes to reduce energy consumption by 40% in 2030, 50% in 2040 and 60% in 2050. **This is driving a huge number of restructurings, requiring significant developer equity.**

- **The ZAN law**, adopted in 2021 as part of the Climate and Resilience Bill, sets the path for a stringent reduction plan of artificialisation of soils, which occurs when cities expand into natural and agricultural lands. **This will progressively stop the outward spread of cities and drive value increase for assets and plots of land inside city boundaries.**

- Multiple restrictions on renting high energy consumption homes are also in place, with more stringent laws being added in 2025 through to 2034, at which point all properties rated 'E' and under on the **Diagnostic de performance énergétique (DPE)** scale of energy efficiency will no longer be rentable.

In combination, developers and land-lords must look upward not outward, investing in efficient land use and the restructuring the existing building stock to ensure France's leading cities can house their growing populations in a sustainable way.

**It is this unique combination of land development and environmental regulation that creates the investment proposition.** Today's inventory of unsold new homes is less than 5000 units across France[4], which along with increasing land plot scarcity supports long-term value appreciation, while asset owners face increasing equity requirements to implement restructuring works.

These factors create the core investment case, maintaining price integrity and ensuring the requirement for investment capital. **But what about short-term macroeconomic challenges? Here, the French market is highly adaptable.**

The system for land pricing in France is supportive of developers over land sellers, with acquisition prices based on assumed programme revenues (price per sqm x number of sqm). This ensures a healthy floor for land plot prices and prevents the market from tumbling into a downward pricing cycle.



[4] Fédération des Promoteurs Immobiliers de France, November 2022

In terms of end-unit purchase financing, mortgage rates have risen across Europe, but French rates remain at the lower end of the range thanks to the prevalence of fixed-rate financing, which supports market stability and reduces the likelihood of a house price crash.

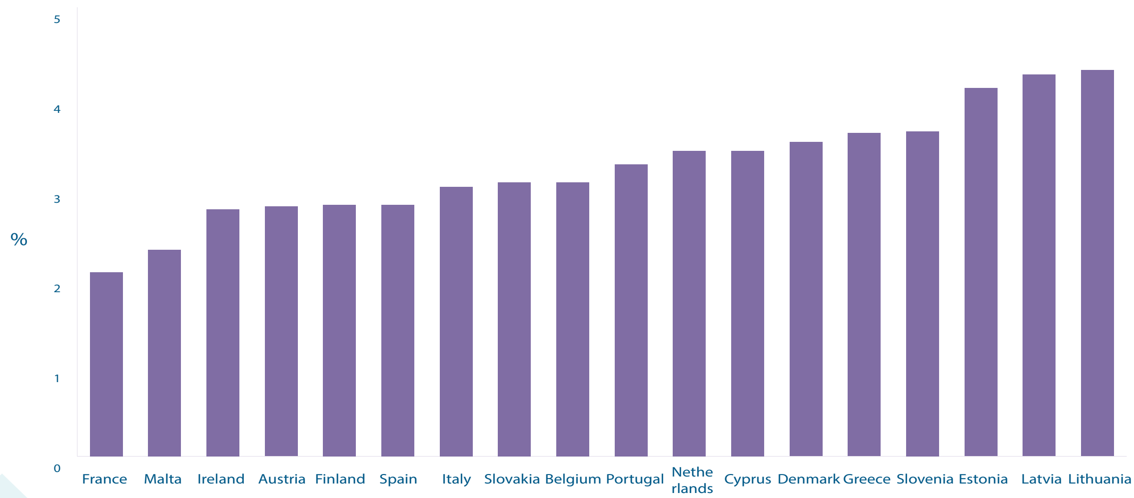
Revenue assumptions are slightly lower today than they were pre-summer 2022. But where individual sales have slowed to reflect economic uncertainty, that demand is being replaced by institutional investors who are re-allocating capital away from commercial real estate towards residential projects in the wake of Covid-19 and the shift towards work from home.

Inflation and supply chain constraints also caused build costs to surge between 2020 and 2022. But the weight of construction costs within the total price is not as high as you might expect given that the bulk of expenses come from engineering fees, which have maintained a more stable pricing structure. Regarding raw materials, the price easing that began to come through in late summer 2022 is accelerating, and as the backlog of orders empties out, total build costs are coming down.

Assessing land prices today, developers assume slightly lower revenues combined with current building costs and set a margin target. Any proposed land price will always be structured to protect this margin.

**CHART 3: EUROPEAN MORTGAGE INTEREST RATE BY COUNTRY**

Annualised agreed rates, all maturities, new business




**Source**/European Central Bank, Macrobond, Mirabaud Asset Management, as at 12 January 2022

**WE BELIEVE FRANCE'S APPROACH TO SUSTAINABLE CITY REDEVELOPMENT PROVIDES A UNIQUE AND ROBUST RETURN GENERATION OPPORTUNITY THROUGH THE PROVISION OF DEVELOPMENT CAPITAL**

Developers also have technical ways of managing costs to protect their margins. New home programmes have so many features it is possible for developers to tweak a spec as a project advances to buffer for cost fluctuations.

This market efficiency created by developer margin protection explains why, during the Global Financial Crisis, there were no bankruptcies among large French developers, despite the pace of sales being well below typical levels.

France's supportive legal framework makes us confident in the long-term valuations of existing assets and land plots. On a short-term view, developers are tackling rates and inflation to maintain profitability through the unique pricing system based around assumed revenue.

For real estate investors, we believe France's approach to sustainable city redevelopment provides a unique and robust return generation opportunity through the provision of development capital, enhanced by the sector's low correlation to equity and bond markets.

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