Investing in French Real Estate:
An American Perspective

by

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ABSTRACT

The real estate investment market in France reflects that country’s peculiarities. Highly centralized in the Paris region and heavily influenced by Government control, real estate has had a particular value to the French. Responding to the convergence of European Union and the development of global markets, France has been liberalizing its economy and privatizing government enterprises. The deregulation through the eighties of the French financial sector lead banks to lend heavily in the property sector so as to increase their yields, just as the Savings and Loans had in the US. This available capital in conjunction with increased demand created an oversupply of product. The recession in the nineties bankrupted many developers and left banks holding large pools of non-performing loans and assets. To preserve their risk-based capital reserves banks were unwilling to write down these assets and just now are beginning to deal with the problem.

As the US real estate market heats up, American investors are looking to find new opportunities. France has been receiving a lot of their attention. The French property market is coming out of six years of recession. The bottoming out of the market and the $60 billion of distressed portfolios are of great interest. However, the French market is comparatively illiquid, non-transparent and burdened with high taxation. Even though economic recovery in France is tenuous and strong demand is not forthcoming, the maturing of the real estate market is providing numerous investment opportunities.

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There has been a lot of interest in French real estate particularly by American investors in the last year. A reduction of opportunities in their home market has been part of the driving force, however, the bottomed out state of French real estate market is making it an attractive option.

The French market in many ways parallels that of the US of the early nineties. A combination of economic growth and available capital resulted in an overbuilt market that crashed when hit with a recession. Financial institutions, many state owned, wanted to profit from the development boom. These banks, insurance companies and holding companies overextended themselves. The result has been a tremendous amount of non-performing real estate assets and loans that financial institutions are just beginning to deal with. Loans were made to developers, who drawn by the booming market, broke French tradition and built speculative projects. Historically, French developers built projects for owner-occupiers or for specific equity financed investors. These investors were dominated by insurance companies, publicly quoted property companies and unit trusts controlled by financial institutions. These companies were woven together in an intricate pattern of cross-ownership and government control. The tradition of government directing industrial and investment policy through direct investment, taxation and regulation resulted in a myriad of legal and tax structures. These have to be well understood to invest profitably in this market.

Government control is waning. Since the early eighties the French public capital markets have been liberalizing and undergoing large privatizations, thus freeing the financial institutions of state control. As these newly public companies try to recapitalize, they have to shed an important quantity of non-performing real estate loans and assets. As a result, there has already been the sale of major portfolios to outside investors, primarily American, but the French are never in a rush to dispose of their assets. Traditionally, real estate had been viewed as a secure long-term asset and a stable low risk investment.
When the economy soured at the beginning of the 1990’s, the financial institutions found themselves with a tremendous amount (estimated $40 to $60 billion) of non performing real estate loans that weakened the French banking system.

France is a centralized country and Paris is the center. The Metropolitan Paris area, (Ile de France), has a disproportionate level of commercial real estate activity, accounting for approximately 80% of the transaction. So many French companies want a Paris office that the government has made it difficult to consolidate staff in Paris and encourages de-centralization with regulations.

The French government plays an important role in the real estate market. Its interventionist tradition means that the government actively participates in the market to get the result it wants. Examples of this type of actions are: the development of new town or business districts such as La Defense, decentralization regulations or SEMs. SEMs (Société d’Economie Mixte) are a public private initiative to redevelop certain large tracts of land, such as the old Citroën factory in Paris.

Unlike the US where real estate is seen as another asset class, real estate in France is viewed differently. The tradition of “La Pierre” (the Stone) gives the French market a peculiarity that makes it difficult for American investors to fully understand. La Pierre signifies the value that the French place on the tangible asset of real estate. It is an attachment to land and a belief that real estate is a great long-term asset, one that is bought and held. From the end of the Second World War to the 1990 crash, real estate continuously went up in value. Government control of capital and a need to rebuild the economy fueled this growth until the mid-eighties when the liberalization of financial markets lead to an increase in speculative construction that crashed in the early nineties. The buy and hold attitude has meant that the property management business has not developed to the same extent as in Anglo-Saxon markets. This attitude is slowly changing as the importance of short-term and medium term value increases and is providing many business opportunities in the property / asset management area.
La Pierre also internalizes the notion of a restricted supply of product. This is particularly true of central Paris (Paris intramuraux) where severe regulations make it extremely difficult to get anything built. There are cases where the restrictions placed on the conservation of portions of a run-down building in a premium location make any efficient redevelopment impossible. With redevelopment constrained, two tiers of supply are developing, particularly in offices. The limited supply of modern space has created opportunities for new offices. La Defense, the business quarter just outside the walls of Paris is one area with interesting development opportunities and has been receiving attention from the likes of Hines and Tishman Speyer, large American developers.

Acquiring real estate in France is not a straight-forward matter. The almost 19% registration taxes due upon sale of an older building complicate the transaction. To avoid these charges, buildings are most often sold within single purpose shells. These can be either corporate (with limited liability) or civil (with unlimited liability) companies. The holding company rather than the asset is sold as the sale of shares is taxed at a lower rate. New buildings, while exempt from registration charges are subject to Value Added Tax (VAT). This 20.6% tax is paid by the first owner of the building, and may be reclaimed against VAT on rental income from the property. If the property is sold to a property trader, marchand de bien, the trader is not liable for the tax, provided the building is sold within five years. If he fails to do so, he will be liable for the tax as well as a penalty. Upon sale, the next owner after the marchand de bien becomes responsible for paying the VAT. The implications of these rules are that it is essential to be well advised on the legal and tax consequences of owning real estate in France, an improperly structured deal could be the difference between a profit and a loss.

The French real estate market is a difficult one to track because of its non-transparent qualities. Current investors who are valuing portfolios of properties are finding that the quality of the information can be low and that they have to make a lot of assumptions. Traditionally French investors looked exclusively at the capitalization rate, without cash flow analysis or internal rate of return calculations. In some cases...
the only information they get is the name of the tenant, though rent rolls are usually available. Sellers are still baffled by requests for information and do not understand why buyers would want to see annual revenue reports. This information advantage has been one of the reasons why US funds have been able to bid competitively on portfolios of distressed real estate assets and loans. While there are still opportunities in this area, they are no longer as profitable. The selling institutions now realize how to do their own workout and sell at less of a discount.

Portfolio sales are interesting because real estate is bought at large discounts. But unlike in the US, the default procedures in France are not clear cut and are extremely lengthy. It is possible that, after a five-year attempt to recover the property, the judge will decide to rule on the borrower's behalf. The other caveat for portfolios is that sellers prefer to sell their premium properties separately. Even if the economy is slowly picking up, it is not a certainty that the secondary properties in these portfolios will increase much in value in the near future.

**ECONOMY**

With the economy beginning to show positive signs, there once again is interest in the market but the turn-around is proving to be fairly slow. The French economy has not in the last five years regained the growth rates of the late 1980s. The average GDP growth from 1991 to 1996 was only 1.15% and, after exhibiting signs of recovery in 1994 and 1995, growth slowed back down to 1.3% in 1996. This slowdown has been attributed to weakened export demand. Yet wage moderation will continue to boost the competitiveness of the economy. GDP levels are expected to rise in the next years and the biggest contributor to this aggregate demand will be the export market. GDP growth is forecast to increase to 2.5% this year and 2.6% in 1998.
Business investment is likely to rebound and pent-up consumer demand, assisted by a rise in the growth of household disposable income, should help to rejuvenate the economy. This activity will help consumer sales and increase the value of retailing properties. Furthermore, relatively low interest rates will help underpin the cyclical upturn. Interest rates have been favorable for the purchase of residential units and the resulting residential construction. These low interest rates contrast the rates that were maintained at a higher level in the early nineties to keep the franc within the bands on European Monetary System (EMS).

One of the key problems of the French economy both politically and economically has been the unemployment level. It has been rising to a record level and although it should peak this year, the downward trend should not break the 12% barrier before 1998. The high rate of unemployment can be attributed to the high cost of hiring. Social security contributions (unemployment insurance, health care,
etc.) are strangling employers and prevent the hiring of extra labor.

The high unemployment rate has been the source of many of the political maneuvering that lead up to the June 2 election. The high rate has lowered consumer confidence in the economy. It has also made it very difficult for the previous government, under Alain Juppé to trim the large public sectors rolls. And, it has been a central issue in the election, with the Socialist proposing to reduce the work-week to 35 hours at the same pay levels.

![Figure 1.3: French Unemployment Rates](source: OECD)

On the other hand, inflation in the past five years is at an all time low, averaging about 2%. Analysts believe these low levels have to do with the strong franc policy as well as the slow down in the economy. The inflation level is expected to remain low over the next two years.

![Figure 1.4: French Consumer Price Index](source: OECD and The Economist)
**POLITICAL CONTEXT:**

When analyzing the French real estate markets, one quickly realizes that there is a strong concentration of activity within the Paris area. This centralization was the creation of the monarchy. Napoleon (1799 - 1814) reinforced these tendencies by creating a system of public administration and a codified system of civil law, both which have survived to this day.

The key to this centralization was *dirigisme*, the ability to direct economic decision. It took particular importance after the Second World War as the government undertook to rebuild the French economy by creating detailed plans for the allocation of resources. During the Sixties this was extended to predicting the course of the overall economy and identifying major social as well as economic objectives. The government used subsidies and the nationalized banks to develop an active industrial policy. Funds were allocated in activities that were deemed to be the basis for growth. These “national champions” such as the Concorde would represent France’s technological prowess in international marketplaces. Until 1985, the French government effectively controlled lending. State-owned banks parceled-out corporate business according to fixed percentages. Financial allocations were combined with the refinancing of selected eligible credits. Moreover, the widespread use of subsidized loans allowed the government to direct investment. The commercial banking system was viewed more as an instrument of industrial policy than as an independent sector assigned the task of efficient capital allocation.

In addition, there are a number of governmental or quasi-governmental financial institutions, which lie between the depositors and the borrowers in the French system -- notably the Caisse des Depôts et Consignations (CDC). The CDC receives funds deposited with the savings banks (*Caisses d'Epargne*) and employs them in housing finance, in local authority finance, and in the purchase of bonds and equities. Because of the dominance of the *Caisses d'Epargne* in the retail deposit market, the CDC commands vast resources and has a significant impact on property markets. It partners up in private -
public development projects. It is also one of the few entities allowed to develop buildings for the
government and state owned enterprises, such as Air France or SNCF.

With the growth of the EC and export markets, French industry was forced to learn to be more
competitive (though the practice of turning to the government for financial help has not disappeared).
By the mid eighties the financial system underwent a transformation, partly as a result of government
efforts to promote Paris as a viable financial market competitor to London and partly as a result of
changing political fashion. The financial market reform shifted corporate finance away from government
controlled and intermediated (bank-dominated) finance towards open capital markets. Furthermore, in
1983, it was decided that the franc would be kept within the Exchange Rate Mechanism (ERM) of the
European Monetary System (EMS) even if this was at the cost of restrictive monetary and fiscal policy.

From a real estate perspective the impact of the new emphasis on capital markets was not particularly
intense, even though there were already listed and unlisted public real estate vehicles. The liberalization,
however, increased competition among financial institutions to finance projects. The economic growth
that paralleled the liberalization fueled a growth in demand for space and a subsequent property boom.

In April 1986, Jacques Chirac was appointed Prime Minister following the Right’s election to the French
legislature. This combination of Left or Socialist Presidency and Right legislature was known as co-
habitation. At center stage in Chirac’s policy were a series of privatizations including the Compagnie
Financière de Paribas and the Société Générale. Returning these financial institutions to the private
sector reduced, albeit modestly, government ownership in the banking sector. The government’s stated
aim was to promote a freer capital market with less government control and direction. During the second

Following the election of 1993, the Right were returned to the legislature, and France entered another
period of co-habitation where the pace of privatization increased with the de-nationalization of financial
institutions such as Banque Nationale de Paris (BNP). With the election of Jacques Chirac to the Presidency in 1995, the privatization platform was reinforced and included the beleaguered Crédit Lyonnais and the national telephone monopoly France Télécom. Neither of these were part of the eleven privatizations completed before the June 2, 1997 election. France Télécom, which was to go to market on June 5th has been delayed by the new Socialist government. A minority stake is expected to be floated in October and signals a willingness on the part of the Socialists to accept public shareholding as a business model.

Through the two phases of the privatization program, most of the French financial institutions have been handed over to the private sector. Yet, France remains over-banked. Competition and imprudent lending in the late eighties have left banks struggling to meet their risk based capital reserves (Cooke’s Ratios). The most notable example is the Crédit Lyonnais. Attempts by the government through the late eighties to create a “Universalbank” left it with a large portfolio of bad loans, a large portion of which was real estate. The bank has repeatedly turned to the state to inject extra capital into its reserves.

The privatization program has an important impact for real estate markets. Firstly, it is a credible signal that the government is liberalizing the economy. More importantly, the government owned financial institutions such as Crédit Lyonnais and GAN have large real estate portfolios. If privatized, they will not be able to turn to the government for help meeting their reserves and liquidity requirements. This will force them to increase the pace of distressed asset disposition.

Concurrent to the privatizations, the financial market has been consolidating. Crédit Agricole, the largest European bank (by “tier-one” capital), recently acquired the Banque Indosuez from the Compagnie Financière de Suez. Similarly, the privatized insurance sector has been undergoing changes. The UAP - AXA merger has created one of the largest insurance companies in the world. Both UAP and Suez had large real estate portfolios and have expressed a desire to divest themselves of the portfolios in order to get the capital needed to reorganize their companies. The insurance company, GAN, however remains in
the hands of the government. It has a large real estate portfolio of non-performing loans and assets, the result of its own investments in the eighties and the forced acquisition of the “Comptoir des Entrepreneurs”, a savings company put to the brink of bankruptcy because of its real estate portfolios.

Conversely, ‘Bancaussenance’, the combination of insurance services with retail banking has become more prevalent. Given that these institutions are only about ten years old, they have little invested in real estate at this time. They have been expanding well in the last couple of years and are becoming cash rich. As such, they are likely to become bigger players in real estate markets.

When working within the French system it is important to note that in the traditional French model, control is maintained through an "insider" system. With this concept of “Etatisme” or Statism it is difficult to draw distinct lines between government and industry or between government and banks. Indeed, the influence of the state was so pervasive in the private sector that managers in many corporations noticed little difference in the operations of firms when they were formally nationalized by the Mitterand administration after 1981 or when some of them were re-privatized a few years later.

Even where formal ownership and regulatory control have been de-linked from the state, the government, the banks and major industrial enterprises remain tied together by informal relationships. The government maintains strong indirect control through a complex “Old Boys” network from the Grandes Ecoles. Graduation from l'Ecole Polytechnique, l'Ecole Nationale d'Administration (ENA), or les Hautes Etudes Commerciales (HEC) guarantees prominence but it also implies service within the government, after which they head to industry positions.

The result of this insider system is intricate pattern of cross ownership that has allowed companies to sweep problems under the rug. As more privatization occurs, public share-holders become more important and companies are forced to deal with problems such as making provisions for distressed real estate.
POLITICAL STRUCTURE:

France is governed by the constitution of the Fifth Republic. The President is elected every seven years and appoints a Prime Minister. The President exercises certain powers independently notably in security and defense. The role of the Prime Minister is to direct operations of the government, which determines and conducts the policy of the nation.

On June 2, 1997 the French elected a new government. The election, called a year early by President Jacques Chirac, resulted in a coalition majority for Lionel Jospin and the Parti Socialiste or Socialist Party. From an economic perspective this election means that the French are now entering their third period of co-habitation. This political duality has created uncertainties as to the direction of the new government in particular with respect to the future of the privatization program and France’s entry in the Monetary Union.

France has been an active member of the European Union. This economic community was originally designed to achieve a common market for goods and services. Over time the European Economic Community (EEC) expanded from the original six members to the present day 15. In 1985, The Single European Act (SEA) amended the original agreement to increase the role of the European Parliament and included new items on social and economic issues. The latest milestone was the Treaty on European Union (the Maastricht treaty) in 1992 which establishes a “European Community” (EC) by amending the original treaties, adding Economic and Monetary Union (EMU) and calling for a common foreign and security policy.

In 1998 the European Council will meet to decide which member states are ready for the final stage of EMU, the locking of exchange rates. To participate, a member’s consumer price index, long-term interest rates and currency stability have to be within the prescribed norms set by the Maastricht Treaty. Since 1993, political changes and the Monetary Union objectives have triggered attempts by the French
government to tame public expenditure growth by tightening the budget and starting social security reforms. The French government deficit in 1997 is expected to be 3.2% of GDP just below the EMU prescribed level of 3.0%. It is expected though to reach the 3.0% in 1998.

**Figure 1.5: French Government Financial Indicators**

For real estate investment, the establishment of EMU will stabilize currency risk for other European investors, making France more attractive to European investors, particularly Germans. It will also mean that over time there will have to be a rationalization of taxation and duties and the onerous 20% property registration tax could drop. However, following the recent elections of June 2\textsuperscript{nd}, the timetable has come into question. Within the first days of forming a new government Lionel Jospin has brought to the table the idea of reconsidering the required timetable for Maastricht. Furthermore, the Socialists are expected to modify government policy with respect to privatization plans, employment focus and social security reforms. The new government is, however, expected to put in place policies that will encourage consumer spending.

It is still unclear how the market will be affected by the change in government. The stock market fell 6% following the assertion that the Right was heavily weakened in the first round of voting. Markets began to rise prior to the second vote and continued to climb even after the Left gained a majority of the legislative assembly. Furthermore, interest rates were barely affected by the change in government.
CHAPTER 2: PLAYERS AND RULES

The role of government in French real estate markets cannot be overstated. Since the end of the Second World War, the State has used taxation and subsidies as tools to rebuild the French economy and generate investment in areas that it deemed to be of strategic importance. For real estate this included the need to quickly build up modern housing stock. After the war there was not only a shortage of housing, but also the existing stock was seriously deficient in terms of amenities such as indoor plumbing. In an effort to create investment flows into the construction of housing the government allocated subsidized credit and created special tax efficient vehicles where investors would benefit from a reduction of corporate taxation.

The residential stock was not the only one to benefit from government encouragement. Until forty years ago, France was still a rural-based economy. To grow into an industrialized country it needed to develop commercial real estate. Just as the government helped develop the residential markets, it created similar plans for the commercial properties. It provided incentives that helped create the primarily owner-occupied, commercial market.

The fact that government also controlled the financial sector meant that there was a balance in the system. Even though there was an extraordinary need for real estate fueled by the economic growth, supply did not manage to overtake demand until deregulation created a property boom in the late eighties. France has recognized the role of free markets and is continuing the trend of deregulation and privatization. The economic and monetary union of Europe will reinforce this recognition and the French government will have to continue its retreat from financial and capital markets.
**THE PRINCIPAL EQUITY PLAYERS:**

On of the constraints in analyzing the ownership of French real estate is that it is very difficult to track down the ownership and determine concentrations of ownership. It is hard to get data, particularly for real estate held in corporate vehicles because the names of shareholders are anonymous.

By far, the larger part of real estate remains residential. The total real asset stock in 1995 was FF 20.1 trillion, of which FF13.3 trillion was residential, (FF11.1 trillion is held by households) and FF6.8 trillion non-residential\(^1\). The latter portion includes commercial property but it also includes public administrations such as hospitals and schools.

<table>
<thead>
<tr>
<th>Owner-Occupied</th>
<th>Rental Housing</th>
<th>2nd Homes</th>
<th>Vacant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public Sector</td>
<td>Private Sector</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Social Housing</td>
<td>Other</td>
<td>Legal Entities</td>
</tr>
<tr>
<td>Rental Stock</td>
<td>33%</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>All Stock</td>
<td>45%</td>
<td></td>
<td>38%</td>
</tr>
</tbody>
</table>

French real estate can be divided into three categories, households and small investors, the government and the institutional investors. When analyzing investment real estate, we focus on the latter group. Until the 1980’s, French commercial real estate was predominately owner-occupied. This meant that historically, institutions invested in residential real estate. With rent regulations in place, the yields on these investments were low and have remained so. Though the French still like residential investment, the opportunity for US investors in this property type is limited given the low yields.

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\(^1\) Source: Le Marché Immobilier Français, IEIF  
\(^2\) Source: Urban Land and Property Market in France
Table 2.2: Approximate breakdown of Ownership
Based on IEIF and INSEE figures
(in FF billion)

<table>
<thead>
<tr>
<th></th>
<th>Home Owners</th>
<th>Quoted Comp.</th>
<th>SCPI</th>
<th>Insurance</th>
<th>Foreign</th>
<th>Public Admin.</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential</td>
<td>5,900</td>
<td>23*</td>
<td>7*</td>
<td>152</td>
<td>-</td>
<td>236</td>
<td>-</td>
<td>13,350</td>
</tr>
<tr>
<td>Commercial</td>
<td>-</td>
<td>55*</td>
<td>67*</td>
<td>95</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>6,800</td>
</tr>
<tr>
<td>Total</td>
<td>5,900</td>
<td>78</td>
<td>74</td>
<td>247</td>
<td>52</td>
<td>-</td>
<td>-</td>
<td>20,150</td>
</tr>
</tbody>
</table>

* Estimated break-down on percentage of areas owned

Institutional investors in France can be divided into five categories: Publicly Traded Property Companies, Funds or SCPIs, Insurance Companies, Foreign Investors and Pension Funds. As in other industries in France, the different investment vehicles are controlled by large financial institutions: insurance companies, banks and industrial holding companies. The major financial groups that dominate the country control most property companies and SCPI management companies through direct or indirect shareholdings. Looking at Créditsuez (Figure 2.1) we see a multitude of different entities, each with different forms of real estate investment, all within this same financial subsidiary of a larger holding company.

Figure 2.1: Partial Organizational Chart of Créditsuez 1993
Source: 1993 Créditsuez Annual Report
Note: Suez has subsequently divested itself of certain real estate assets
Looking at investment into property assets over the last ten years, we notice that in recent years the only funds flowing in have been those of foreign investors. The French players, whether quoted companies, SCPI or insurance companies have not been active participants.

Since 1992, a new type of ownership has appeared. Following the real estate crash, the banks and insurance companies became major owners of property. This was the result of their having taken equity stakes in projects and the foreclosure of loans to the development sector. To take these bad loans and property off their books, they created separate entities or defeasance structures that remained controlled by their shareholders. The purpose of these is to improve the parent company’s balance sheet and to establish a structure within which to wind down the real estate investments. The best know are the Consortium de Réalisation (CDR), Crédit Lyonnais’ structure and Baticrédit, GAN’s structure.

**Quoted Property Companies:**

Quoted property companies are real estate companies listed on the French stock exchange (*Bourse de Paris*). They are sponsored by the large financial institutions and generally do not lever up. Companies are not required to get annual appraisals. Their assets are reported at book value but can be written either up (a taxable event) or down. Given that they have traditionally been considered income stocks, analyst
focus on yields.

Following poor performances and the general malaise in the market over the last few years, these companies are often trading at discounts to NAV (Net Asset Value) as calculated by analysts. This presents an opportunity to mirror the consolidation in the US REIT market by purchasing French companies, repositioning them, leveraging them up and adding franchise value.

As of December 1996 there were 50 quoted real estate companies with a market capitalization of FF78.78 billion. The property stocks accounted for about 2.6% of the total equity market capitalization.

Table 2.3: Market Capitalization of Major Asset Classes

<table>
<thead>
<tr>
<th>Year</th>
<th>Equities (incl. Real estate)</th>
<th>Property Companies</th>
<th>Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>2,445</td>
<td>78</td>
<td>4,133</td>
</tr>
<tr>
<td>1996</td>
<td>3,073</td>
<td>79</td>
<td>4,606</td>
</tr>
</tbody>
</table>

In 1996, the SBF 250 index, which is a basket of French equities representing about 90% market capitalization, registered a return of 23%. In the same period, the general property index of quoted companies registered a return of 5.8%. This aggregate return incorporates variations. Simco, one of the largest companies specializing in residential property with a market capitalization of FF 7 billion, had a return of 1% while the medium sized Foncière de Pimonts which has a market capitalization of FF 513 million returned 44%3.

Most quoted property companies are known as Foncière. This refers to the fact that they specialize in real estate. (Foncier means property). The first Foncière dates back to the building boom in Paris in the 1860’s. These vehicles allowed private individuals to finance the construction of large areas of middle class apartments in Paris and Lyon. Some of these still exist to this date. Foncières are set-up as Société

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3 Source: IEIF, Transbourse

Return = (Share price on 31/12/96 - Share price on 31/12/95 + gross dividend in n)/ Share price on 31/12/95
Quoted Property companies can be divided into two types of activities. Those that own real estate portfolios with the intent of renting out the space to tenants and those who own real estate as a financing arrangement. The latter are leasing companies that use a structure known as crédit bail (credit lease). It is a long-term lease, generally 12 to 15 years, where a financial company leases out commercial space that it has bought or built for a tenant. Upon expiration of the lease the tenant usually takes ownership. It allows tenants to deduct both principal and interest components as expenses. It is essentially a structure to provide owner-occupier financing.
Originally crédit bail were structured as SICOMI, (Société Immobilière pour le Commerce et l'Industrie). These Property Companies for Commerce and Industry were created by the French government in 1966 to channel private savings into industrial real estate but the status was phased out in 1990 as part of tax reforms. Another tax efficient vehicle which was phased out to increase tax revenues, was the SII (Société Immobilière d'Investissement) or Real Estate Investment Company. As of 1996, all SII have changed their statuses to straight foncière.

**SCPI (SOCIÉTÉ CIVILE DE PLACEMENT IMMOBILIER)**

SCPI or Civil Companies for Real Estate Investment are unquoted real estate trusts. They can be either open-ended or closed-end funds. They are saving vehicles, mostly managed by banks and financial groups that offer real estate investment products to private investors. Their only purpose is to invest in real estate either commercial or residential and to manage their portfolios. They are not permitted to sell or renovate their real estate except within strict guideline that enhances the long-term value of the property. They must hold on to a property for a minimum of six years and cannot dispose of more than 5% of their total asset value per year. The maximum management fee they may charge is 10% of rental revenues and the maximum allowable commission on the sale of shares is 5%. Though permitted to use debt, the SCPI prefer to use equity. There has been consolidation in the SPCI as they try to reach a critical mass required for economies of scale. In 1996 there were 10 mergers and acquisitions, up from 6 in 1995.

The main advantage of the SCPI is that it is a pass through vehicle with no corporate taxation. Taxes are paid directly by the investors as direct rental real estate income. Sponsored by large financial institutions, banks, insurance companies and holding companies, they allow small investors to participate in real estate markets. This explains why ownership of SCPI shares is widely diffused. There are about
600,000 shareholders, with an average holding of FF120,000$^4$.

The major shortcoming of this market with a capitalization of FF74 billion is that it is not a very liquid. It can take six months to dispose of shares. The 273 different SCPIs manage their own secondary market, fixing the price at least once a year. Some managements are less willing to lower their settlement price. This distorts the market, as these prices do not reflect transactions and makes it very difficult to assess true returns.

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$^4$ IEIF - Réflexions Immobilières No. 17, April 1997
Table 2.4: Top Ten Principal SCPI Management Groups
(Capitalization of funds managed, by unit price, Dec. 31, 1995) Source: IEIF

<table>
<thead>
<tr>
<th>FF bn</th>
<th>% Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crédit Agricole</td>
<td>10.57</td>
</tr>
<tr>
<td>Banque Paribas, Crédit du Nord</td>
<td>7.25</td>
</tr>
<tr>
<td>U.F.G. - Crédit Mutuel</td>
<td>5.32</td>
</tr>
<tr>
<td>Pelloux (Independent)</td>
<td>4.29</td>
</tr>
<tr>
<td>C.I.C. / Commercial Union</td>
<td>3.98</td>
</tr>
<tr>
<td>ISM SA (Suez Group)</td>
<td>3.91</td>
</tr>
<tr>
<td>Caisse des Dépots (Caisse d'Epargne - Poste - Trésor public - Caixabank)</td>
<td>3.84</td>
</tr>
<tr>
<td>GPD (Independent)</td>
<td>3.48</td>
</tr>
<tr>
<td>Banque Nationale de Paris</td>
<td>3.44</td>
</tr>
<tr>
<td>Crédit Lyonnais</td>
<td>2.58</td>
</tr>
</tbody>
</table>

**INSURANCE COMPANIES:**

In France the insurance companies are the largest group of institutional real estate investors. This is further accentuated by the lack of pension funds and the fact that mutual or open-ended funds (SICAVs) have concentrated on money markets, bonds and more recently equities. The insurance sector in France is dominated by several large insurance companies and a series of smaller mutual companies. The total aggregate market value of the real estate held by the insurance sector was FF 247.8 billion at the end of 1995. This was a decrease from FF270.1 billion in 1994. Insurance companies, which had traditionally invested heavily in real estate equity, were hit hard by the crash. They were saddled with non-performing loans and assets. Going forward, they need capital to undertake new investments in other markets. As such they are beginning to divest themselves of these assets. They are disposing of both performing and non-performing assets to provide capital. They are particularly interested in selling older assets that are held at book value. The sale allows them to mark to market the asset value and incorporate the higher amount into their capital reserve requirements. As a result, real estate now plays a less important role in the portfolios of insurance companies. This decline combined with the increasing
investments in the French stock market has meant a decrease in the percentage of real estate held. In 1985, property assets of FF82.7 billion (FF 109 billion in 1995 francs\(^5\)) represented 17% of the portfolio compared to 7.9% in 1995. This percentage decrease represents the growing importance of the French equity market and a shift in the relative weight that insurance companies place in real estate. The proportion of capital allocated to real estate is not expected to increase significantly above current levels.

| Table 2.5: Property Portfolio of the French Insurance Industry |
|---|---|---|---|---|---|---|---|
| | Paris | Paris | | | | |
| | City | Region | Province | Foreign | Total | % Share |
| Housing | 2,836 | 2,241 | 1,529 | 6 | 6,613 | 47% |
| Offices | 2,299 | 1,958 | 1,063 | 51 | 5,372 | 38% |
| Industrial | 96 | 372 | 418 | 0 | 886 | 6% |
| Retail | 421 | 319 | 258 | 5 | 1003 | 7% |
| Other | 117 | 114 | 104 | 1 | 336 | 2% |
| **Total** | **5,770** | **5,003** | **3,372** | **63** | **14,209** | **100%** |

% Share 41% 35% 24% 0.4% 100%

**Note:** These statistics concern the members of FFSA, which accounts for 90% of the sectors’ turnover

1 square meter equals 10.76 SF

**FOREIGN INVESTORS**

Foreign investors have been extremely active in the French market in the last two years, but generally they were not newcomers to the market. British, Arabs, Swedes and Japanese were particularly active in the late eighties when Paris was developing into a European business center. They were attracted by strong value appreciation of the booming market. Foreign investors have preferred to invest in the Paris office sector, though there are some investments in shopping centers and a marginal amount in industrial properties. With the exception of some Dutch and German investors there is no foreign investment in residential real estate.

In 1995, foreign investors invested heavily in shopping centers. They bought both individual assets and

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\(^5\) Estimate based on OECD Consumer Price Increases
property companies. Though there were not a lot of transactions, because of the size of the purchases and the lack of real estate investment overall, these transactions had a significant impact on the market. In 1996 foreign interests in French Real estate reached approximately FF 52 billion\(^6\). 1996 was also the year when the American investors were very active in the French of mortgage portfolios. One group that has yet to really enter the market are the Germans. Under current German laws, open-ended funds may only purchase real estate as direct assets and not as shares in real estate companies. In France most real estate is owed in single purposes shareholder entities in order to avoid transfer taxes. This legislation is expected to change shortly which could bring German money into play.

**PENSION FUNDS:**

The Pension system in France is essentially a government-based system. The system of *Caisse de Retrait* (retirement funds) is a pay-as-you-go scheme with comparatively little capitalization. It is more of an extension of the social security system (healthcare, unemployment insurance, family benefits etc.) rather than a system of independent financial institutions and is influenced by Union concerns. Given the short-term funding horizon most pension investments are in financial and government securities. Most pension funds are organized by trades. There is no central organization and as such there is limited information on their investments portfolios. However, some of the larger funds are known to have built up real estate portfolios. These represent a small percentage of their portfolios and are largely residential in nature.

**DEVELOPERS:**

Developers in France are not investors in real estate. They rarely build to own property as a long-term investment. They are short-term players and operate with about 20% of equity. Their intention is to sell

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\(^6\) Source: IEIF
the finished product and generally do not begin a project until the take-out investment is in place. Once
the latter is established they search out equity investors for the development process. During the boom,
ythey undertook speculative projects hoping to find buyers once the project was completed. Banks
wanting to cash in on the growth, lent liberally, sometimes up to 100%, and often with participating
mortgages, hoping to benefit from the upside. The ensuing oversupply hit the market at the same time as
the recession and many of the developers had to be bailed out. The result for financial institutions was
that they became owners of a lot of non-performing real estate.

Developers can be divided into two categories: the “promoteur”, or developer-builder, and the
“marchand de biens” or property trader. The promoteurs are service companies. They often belong to
well capitalized, financial or construction companies. They take on little risk and carry out development
on behalf of an investor or owner-occupier. As a result of speculative projects in the eighties,
approximately two thirds of the promoteurs disappeared. Of the ten large promoteurs active in the late
eighties, only three remain.

The property trader, Marchand de biens, is a form of broker who benefits from a special tax status
exempting him from registration duty (droits d’enregistrement) on the purchase on property provided it
is resold within five years. These are private firms or subsidiaries of promoteurs and financial
institutions that bring different participants (sellers, buyers, promoteurs) of a project together. By law
they must be habitual traders and are subject to VAT (Value Added Tax) on the gross profit made during
the holding period.
**THE CREDIT MARKET:**

Most French institutional investors use only equity, though a few foncière use leverage. Real estate finance was therefore traditionally limited to short-term development financing. The property crash of the early nineties changed this. The French financial institutions were highly exposed to real estate loans. In 1995, there was a cumulative exposure of FF 315 billion, of which more than two thirds was delinquent. In order to deal with this debt, the financial institutions have created defeasance structures that transfer the loans off the balance sheets.

**THE RULES: TAXATION AND LEGAL**

When it comes to taxation, France faces a dilemma. On one hand the high social charges of the government structure requires important taxation revenues. On the other hand, there is a tradition of intervening into public markets to direct policy. The result is that France is burdened with high taxation rates but riddled with legal maneuvers to avoid these. It has been hypothesized by local brokers that of all the recent large transactions (See Table 5.2), none paid the full 19% registration tax. Therefore, to successfully invest in French real estate, it is important to fully understand the tax laws and how they are circumvented.

**REGISTRATION TAXES**

Taxes on the acquisition of property are particularly onerous. Upon acquisition of a building in France there are either registration taxes (droits d’enregistrements) or VAT (Value Added Tax) to pay.

The droits d’enregistrements (registration tax or duty) are specific taxes paid to local government upon the sale or transfer of property. These are payable by the purchaser of a building that is over five years
old and is not newly renovated. It consists of three taxes:

<table>
<thead>
<tr>
<th>Tax</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>droit départemental</td>
<td>15.785%</td>
</tr>
<tr>
<td>(department tax)</td>
<td></td>
</tr>
<tr>
<td>local tax</td>
<td>1.200%</td>
</tr>
<tr>
<td>regional tax</td>
<td>1.600%</td>
</tr>
<tr>
<td></td>
<td>18.585%</td>
</tr>
</tbody>
</table>

Registration taxes are also due on the sale of companies, however, the rates are much less than those for real estate assets (see Legal Vehicles). The result of the tax is that most properties are set up within single purpose companies and the companies’ ownership is transferred. When purchasing through these vehicles a thorough audit should be prepared on the property. In a sale of shares there is not a statutory legal guarantee vesting the purchaser with full proof of asset ownership as there is in a real estate asset transaction. In an asset transaction a notary must keep the original deed and is paid approximately 0.825% of the purchase price for this service. In addition to the notarial fee, a land registry fee of 0.1% is payable on the higher of the market or transfer price of the property.

**VAT (VALUE ADDED TAX)**

A VAT of 20.6% on the purchase price is collected in the following cases: the purchase of land where the owner is committed to building within four years; the purchase of a building to be demolished or to be entirely renovated; the purchase of an incomplete building; the first sale of a building which has been completed for less than five years. If the investor wants to recover his VAT, he must ensure that the building rents are subject to VAT. In general, rent is not subject to VAT. Leasing furnished units (residential or commercial) is subject to the tax but the renting of unfurnished or unequipped premises are not automatically subject to VAT. In the case of a new building, if an investor wants to reclaim the VAT that was paid upon purchase, he must obtain the right to do so through a special option from the tax authorities. If the investor charges the VAT during a ten-year election, the period is automatically

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7 Source: Clifford Chance
renewed for another ten-year period if the investor benefits from VAT recovery. If no VAT is charged, a 2.5% stamp duty per annum on the rental amounts has to be paid by the owner.

**Figure 2.5: Comparative purchase taxes and tax on subsequent rental revenues**

<table>
<thead>
<tr>
<th>Purchase Asset</th>
<th>Purchase Asset</th>
<th>Purchase Holding Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Building</td>
<td>21% VAT</td>
<td>Rent</td>
</tr>
</tbody>
</table>

**CORPORATE TAXES:**

The corporate tax rate is 33.3% plus a surtax of 10%, or 36.6% on revenues. Depreciation expenses are allowed and vary from 5% per annum for warehouses to 1-2% per annum for premium properties in Paris. Losses from depreciation write-off can be carried indefinitely but ordinary operating losses can only be carried five years.

When disposing of a property, the capital gains are somewhat different from the US model. If a building is sold within two years after acquisition, the seller is liable to pay tax at the ordinary rate of 36.6% (33.3% plus 10% surtax) on the capital gain. If sold after two years, it benefits from a tax rate of 20.9% (19% plus 10% surtax) provided the company is not deemed to trade in real estate. The reduced rate applies to that amount that exceeds the original book value, while the depreciated amount is tax at the ordinary rate. When using this reduced rate, the gain must be placed into a special reserve for re-investment purposes. This reserve will be used by the corporate entity for future investment. If it is distributed to shareholders, it will be liable for extra taxation to bring the tax rate up to the 33.3%. The additional tax is not due if the company is wound up.
**OTHER TAX CONSIDERATIONS:**

When setting up the ownership structure, the tax consequences must be considered because of French capital and withholding taxes. If a company owns real estate that represents more than 50% of its French assets, it is liable for an annual 3% capital tax on the market value of the asset. Exceptions are made for property used in the execution of a commercial activity. Property trading is considered a commercial activity but investment is not. This may be avoided if the entity owning French real estate is located in another country that has tax treaty with France.

The ownership entity situated in another country may also be subject to withholding taxes on dividends or disbursements. Non residents are potentially liable to pay a 33.3% withholding tax on disbursements of capital gains on sale unless the owning entity is located in a country with a tax treaty. They are also liable to pay a 25% withholding tax on dividends if after-tax profits are paid to the parent company. Pursuant to EC directives, these can be eliminated under certain conditions if the owning entity is located within the EC. As such, certain investors will set up an intermediate holding company based in States
such as Luxembourg to minimize tax liabilities.

**LEGAL VEHICLES:**

If investors were to look exclusively at the tax code in France, no one would invest. There are, however, ways to minimize these liabilities. It is French taxation law that makes legal structure of investment vehicles very important. Real estate investments may either be executed using a corporate structure or through a civil or partnership-type structure.

The different corporate options available are *SA* (Société Anonyme), *SAS* (Société par Actions Simplifiée), and *SARL* (Société à Responsabilité Limitée) whereas the partnership vehicles are *SNC* (Société en Noms Collectif) and *SCI* (Société Civile).

<table>
<thead>
<tr>
<th>Table 2.6: Ownership Types</th>
<th>Liability</th>
<th>Paid in Capital Required</th>
<th>Shareholders</th>
<th>Transfer Registration tax</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SA</strong></td>
<td>Corporate, limited Liability</td>
<td>FF250,000</td>
<td>Unlimited</td>
<td>0 or 1%</td>
<td>Larger, only form that may be listed on the Stock market, need for Board of Directors and Management Committee</td>
</tr>
<tr>
<td><strong>SARL</strong></td>
<td>Corporate, limited liability</td>
<td>FF50,000</td>
<td>2 - 50</td>
<td>4.8%</td>
<td>Smaller, more flexible</td>
</tr>
<tr>
<td><strong>SAS</strong></td>
<td>Corporate, limited liability</td>
<td>FF1,500,000</td>
<td>min. of 2</td>
<td></td>
<td>Used for Joint ventures, no Board needed,</td>
</tr>
<tr>
<td><strong>SNC</strong></td>
<td>unlimited, joint and severally liable</td>
<td>None</td>
<td>min. 2</td>
<td>4.8%</td>
<td>Fiscally transparent (pass through)</td>
</tr>
<tr>
<td><strong>SCI</strong></td>
<td>unlimited</td>
<td>none</td>
<td>min 2</td>
<td>4.8%</td>
<td>Fiscally transparent, can carry out only civil activities.</td>
</tr>
</tbody>
</table>

The concept of civil companies in France parallels the American concept of an un-incorporated company or partnerships. For real estate the *SNC* is preferred over the *SCI* because it will not lose its pass through status if it undertakes activities that qualify it as a commercial operation. Real estate rental is considered a civil rather than a commercial activity. If rents are based in certain circumstances, in part or in whole on the turnover or profit of the tenant, then the activity becomes commercial in nature. Under these
circumstances a SCI would lose its civil, pass through, status and become taxed as a SA or SARL. Civil in this case refers to a legal concept that essentially differentiates between the activities of private citizens such as a professional practice versus commercial business undertakings such as retailing.

**LEASES:**

**COMMERCIAL LEASES**

Commercial leases in France are governed by a national law, the Decree of September 30, 1953 (the Decree). The duration, renewal and termination of the lease, rent revisions, permitted uses, subletting and assignment are all covered by the Decree.

The minimum period allowed for a lease is 9 years while the longest is 99 years. If the lease is over 12 years in length it must take the form of a notarial deed and be published. It will also be subject to a 0.615% duty levied on the rent to be paid during the lease. There are special provisions under certain circumstances for short, less than two years, leases. The tenant, however, has the right at the end to remain in the premises for another nine years without any formalities under the same condition accorded by a standard nine-year lease.

The heart of the French commercial lease is the 3/6/9 lease. It is known as such because the tenant has the right to terminate the lease every three years with six months notice. The tenant is allowed to waive this right in the lease contract and as such a six year minimum is becoming more popular. Landlords on the other hand have the right to terminate every three years only when important construction works are undertaken on the premises. The tenant has an automatic right of renewal at the end of nine years provided that the same commercial undertaking has been carried out for the last three years preceding the expiration. The landlord may only refuse to renew if he provides compensation based on the market value of the business, the cost of moving and reinstallation costs.
The Decree provides a rent review every three years. This cannot exceed the variation provided by the construction index published quarterly, the *Indice du Coût de la Construction (ICC)* or Construction Cost Index, calculated by the French national statistics institute, (*INSEE*). It is possible to index the rents annually. There is an exception to the maximum possible. If the market value of the rent increases by more than 10% because of changes in local environment, rent is allowed to be marked to market. Changes are defined as changes in: the size of a town; the area or street; the other activities carried on around the premises; local transportation networks and attractiveness of the site for business. It is, however, possible to review the rent downwards. This has been the situation recently. With falling market rates, tenants have renegotiated rents downward and most leases have become marked to market.

When renewing a lease at the end of its term, the increase in the rent is limited to the ICC rate increase. An exception is made for premises that are used exclusively for office purposes, for buildings that can only have one use (*Locaux monovalents*) and where the lease has a duration of more than nine years.

Subletting is prohibited by the Decree unless agreed upon by both parties in the lease. Assignment of leases is possible, unless prohibited in the lease but generally restricted so that the owner approves the assignment and the lessee remains jointly and severely liable. The owner cannot prohibit assignment in favor of a purchaser of a lessee’s business.

Maintenance and repairs are not covered by the Decree. The current practice increasingly tends to push these costs to the tenant, whether the repairs are minor or structural. This is particularly true in the cases where the tenant occupies an entire building.

**TENANT IMPROVEMENTS:**

French law considers that all fittings that are attached to the building belong to the owner after they are incorporated. The lessor cannot request that a premise be return in its original state. If the improvements were major construction works, the transfer of these back to the owner at the end of the
lease is considered as a capital gain and is taxed as such. If during the lease the tenant undertakes to improve the premises, the landlord is restricted to the ICC cap for the first renewal of the lease. The second renewal (9 years later) can be set by the landlord at market levels without considering the ICC rental rate cap. If the owner undertakes the construction, the first renewal is not capped and can be reset at market rates.

**Residential Leases**

Residential leases are signed for a minimum of three-year terms and must stipulate rent review intervals. The tenant can terminate the lease at any time by giving a three-month notice. The landlord has the right to terminate at the end of the lease provided he gives a six-month notice. At the end of the lease, the owner is free to set the rent level, however, during the lease increases are limited to the ICC increase.

**Financial Leasing:**

This form of leasing known as *crédit-bail* is a transaction where a financial company purchases a building in order to rent it to a lessee for a period usually between 12 to 15 years. At the end the lessee usually takes possession of the property.
CHAPTER 3: MARKET CHARACTERISTICS

The French market can be divided into residential and commercial properties. The areas of greatest interest from an investment perspective are the office sector in commercial though there is a strong historical preference among French institutions for residential properties.

Statistically, the government measures the value of residential and non-residential real estate assets. In 1995, the value of the residential real estate assets were estimated at FF 13.3 trillion, of which FF11.1 trillion was held by household and FF 236 billion was held by public administrations. The non-residential portion was FF6.8 trillion. The problem with the non-residential statistic is that it includes all non-residential assets including schools, hospitals etc.

In terms of investment, French institutions have had a distinct preference for residential properties and there is a large stock of multi-family properties to satisfy them. In 1994, there were 9.9 million apartment units in comparison to 12.6 million private homes. This national average of 44% housing stock in apartments increases to 73% for Metropolitan Paris and 99.6% for the City of Paris. Rent regulations have kept the returns on this property type low. As result, residential investment has not attracted great interest by foreigners with the exception of some Germans for whom the yields are higher than those in Germany. Office buildings have been the second area of interest. Given that they receive the lion’s share of activity, there is more available information on this property type.

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8 Source: Le Marché Immobilier Français, IEIF
**RESIDENTIAL:**

Multi-family residential real estate has long been an important part of the portfolios of French foncière and insurance companies (see Table 2.2). Historically, high commercial owner-occupier rates made residential the predominate real estate investment option. At the same time, rent regulations and the pegging of rental increases to the ICC have kept rents low.

Following the Second World War, the housing stock in France was in poor shape. A lack of investment resulted from rent control instituted in 1918. In 1948, rents levels were barely one tenth of their levels in 1914 in terms of purchasing power and only returned to 1914 levels in 1990⁹. Demand, which came from a migration into the cities and over a million French colonists returning from North Africa, outpaced supply. To address the problem the government encouraged pooled investment accounts to attract capital to multi-family housing.

Investments into the residential markets have been very sensitive to the regulatory environment. The socialist Quillot Law in 1982 severely regulated the rental housing market and discouraged private investment. In 1987 the Méhaignerie Law suspended most of the provision of the old rent control laws and this encouraged investment in the late eighties. In 1995 the Périssol Laws were introduced to again encourage new construction or renovation in residential property.

Currently there is an arbitrage opportunity in apartment buildings. Pricing on yield gives a substantially lower value than pricing based on individual unit sales. With low mortgage rates, there are more potential purchasers of units. Consequently, French institutions are selling off either properties from their portfolios, or newly acquired ones. This is also an opportunity for US investors. It is, however, a short-term horizon investment tied to increasing household sales in a period when traditional
institutional investors shy away from purchases.

Generally, investment into residential property is a limited market for Americans. Rather it is of local interest because of low yields. The French investors are willing to pay a premium to own this type of property with its steady income stream, they generally invest with 100% equity and consider the risk profile comparable to the bond market. From an American perspective though, this market is less interesting. American investors are not interested in low yield - low risk real estate investments in foreign markets.

**Residential Returns:**

Residential yields have been going up. In the city of Paris they were only 6 - 6.5% (net of charges) in 1996, up substantially from their 1991 levels of 3 - 3.5%. Outside Paris in Provincial markets yields were 7 - 8% in 1996 compared to 5% in 1991. The reason for this increase has been a 10-15% drop in rents and resulting income divided by a greater 30-35% drop in capital value. These are both decreases from rent and capital value peaks in the early nineties.10

**Commercial**

The commercial real estate market in France can be broken down into three property types: Office, Retail and Industrial. For investors, the office market has been the most attractive sector of real estate and as such remains the most important part of their real estate portfolios.

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9 Guy Marty, “La Culture Immobilière”, Institut de l’Epargne Immobilière & Foncière
10 Source: Le Monde, October 17, 1996
OFFICES:

Up until the 1980’s offices in France were primarily owner-occupied. This has created a market that to this day is still more user driven than investment driven. Offices were in the center of the city and were in formerly residential buildings converted to offices with little structural change. As the demand expanded, there was a need to create dedicated office buildings but construction was restricted in the City of Paris. To alleviate the lack of space, new communities outside the walls of Paris were created. The most important was La Defense, just west of Paris.

In the mid 1980’s the French government decided in a typical dirigiste fashion that it would encourage the development of Paris as a European office center and alternative to London. To encourage this, it eased restrictions on construction of new offices. Furthermore, the London market was expanding exponentially with the “Big Bang” deregulation of financial markets. London rents were rising quickly and Paris was seen as an arbitrage opportunity by foreign investors such as the German and the English.

![Figure 3.1: Take up (Absorption) of Office Space in the Paris Region in million sq. m. (excluding turn key developments)](image)

As a result, the 1980’s saw an explosion in the development of offices in Paris. These varied in quality from superficial renovations to construction of modern office space. From 1985 to 1996, the office stock in the greater Paris area grew from 27 million (291 million SF) to 40 million square meters (431 million SF). In the early 1990’s, the property market crashed. Reduced demand coupled with an oversupply of
office space raised vacancy rates from 3.5% in 1990 to almost 10% in 1995, for the Metropolitan Paris area.

**Figure 3.2: Available Office Space in the Paris Region within 12 months**

As of 01/01 (in Millions of sq. m.)

Just as in US cities, the recession caused a shift out of poorer space into better-located, modern, adapted space. The resulting secondary space, some built in the early eighties, does not suit modern technological requirements particularly in terms of flexibility of partitions, air conditioning and modern telecommunication cabling. Some of this secondary space is being reconverted into apartments. In 1996, approximately 110,000 m² (1.2 million SF) were converted to residential use.

In the eighties as the market began to explode, the French financial institution who up to 1970 invested primarily in residential real estate began to acquire commercial real estate. The first projects were offices converted from residences. These were followed by first generation office buildings in the 1970’s that are now deficient in terms of modern requirements. During the 1980s they continued to invest in top quality space of the time, though they left many of the landmark buildings for the foreign investors in the 1988 - 91 boom.

As in US cities, office space in Paris can be divided into three categories: marketable space, space that requires refurbishment and unleaseable space. The primarily reasons for the unleaseable space are that it is
poorly located, the space is badly configured or the cost of refurbishment exceeds the market value and there are problems with permitted uses.

**Figure 3.3: Breakdown of Available Space in Paris by Marketability**

![Pie chart showing the breakdown of available space in Paris by marketability.](chart)

<table>
<thead>
<tr>
<th>Marketability</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obsolete</td>
<td>11%</td>
</tr>
<tr>
<td>In need of refurbishment</td>
<td>24%</td>
</tr>
<tr>
<td>As is</td>
<td>65%</td>
</tr>
</tbody>
</table>

Source: Bourdais

**LOCATIONS:**

The total office stock in the Paris region is 40 million square meters (431 million SF). Of this 15 million, (38%) are within the boundaries of Paris (Paris intramuraux). The principal areas are in the central and western arrondissement (administrative districts). The prime office areas are the Triangle d'Or (Golden Triangle) in the 8th arrondissement and the CBD (Central Business District) where there is approximately 8.5 million m² (91 million SF). Within the city of Paris, office space is limited by the fact that it is now nearly impossible to convert residential use to commercial use. Office space has to have a “qualification bureau”, (be qualified as an office). This means that any new space will have to take over existing office use. This limitation on supply presents an opportunity but the severity of regulations governing construction within Paris can make it very difficult to create efficient, cost effective projects. Understanding the different regulations and how to present a project to authorities, can be the source of a distinct competitive advantage just as it can in cities like Boston or San Francisco with their complex entitlement process.
The suburban (*banlieue*) market, is the urban or semi-urban area that surrounds the city. In terms of office space, the most sought after areas are the *Croissant d’Or*, or Golden Crescent. This crescent shape flanks the western edge of the city, where the real estate values have been historically higher and consists of six communities from Levallois-Perret to Boulogne-Billancourt. The area with the greatest concentration is La Defense. Situated on the western edge of the city, along the prolongation of the Louvre - Arche de Triomphe axis, this area has 2.1 million m² (226 million SF) of office space and is well served by freeway, public transit and a new high speed railroad station to be completed shortly. Originally viewed as a back office area, La Defense has gain favor in recent years as one of the few locations in the city where large contiguous spaces are available.

Office buildings in France are smaller than those in the US. The preponderance of office space is within the City of Paris where building height is capped by law at 28m (92 feet). This restricts the number of available floors. The result is that the average building in Paris is about 3,000m² (32,291 SF) or about 450m² (4,845 SF) per floor while companies now want 1,000m² (10,765 SF) flexible, floor plates. This has been a driving force behind the increased desirability of La Defense where it is possible to build
much higher towers with larger floor plates. This is not to say that new space in the suburbs is not heavily regulated. For example, regulations prescribed the maximum distance of interior office space from windows. This makes French buildings narrower than their American counterparts.

**RETAIL:**

While not as retailed as the UK or the US, retail property in France is very unique. This comes from the fact that it will be very difficult to build new large retail space. Small shops (*petit commerçant*) have important roots in French culture. The tradition of the village shop and the local café has persisted because of the cultural attachment to the quality of food. The result is that central shopping areas have been able to resist the assaults of shopping centers. In 1994, the estimated total national stock of individual shops was 55 million m². This is in contrast to the 12.6 million m² (136 million SF) of shopping centers (defined as over 5000 m² {53,800 SF} and over 10 shops). Of these 603 shopping centers only 35 were over 40,000 m² (430,500 SF). Overall, this amounts to approximately 12½ square feet of retail space per capita which falls short of the US which has about 20 square feet of retail space per inhabitant.

![Figure 3.5: Area of Shopping Centers](image)

The number of shopping centers remained low because as they developed in the 1960s shopkeepers were
swift to react. In 1972 the restrictive Royer Law was passed and regulated shops over 3,000 m$^2$ (32,300 SF). Authorizations were required to build and these were given at the local level by a commission that included shopkeepers. The legislation was strengthened in 1990 and in 1993. In 1996, reacting to the strong small merchants’ lobby, the Raffarin Law was passed. It began by freezing all new shops for a period of six months after which time the threshold for special permits was lowered to 300 m$^2$ (3,230 SF). A permit is now also required for shops wanting to extend over the 300 m$^2$ and for shops wanting to change uses (300 m$^2$ for food use and 1000 m$^2$ {10,760 SF} for other uses).

The impact of the law has been to restrict the supply of large retail units. Shops that were previously regarded as secondary are becoming sought after. Many retailers are purchasing “fonds de commerce” (business/goodwill) in order to acquire large main street units. Given the difficulty of obtaining new permits for shopping centers, the key lies in taking advantage of existing centers and trying to improve them.

Like in the US, large shops also anchor shopping centers. The difference is the type of shop. In France they are anchored by large “hypermarché” or combination supermarket, small department store such as Carrefour. These facilities tend to be owned by the users. Most leases are granted for twelve years and incorporate a variable element based on turnover that typically amounts to 5 to 7 percent of gross turnover. Another distinction is that French shopping centers have not yet undergone a lot of renovation. Given that competition is limited, they are more likely to maintain their outdated interiors for longer than their American counterparts.

*INDUSTRIAL:*

France was until the 1960s a rural based economy. As such, much of its industrial building stock was built after that time and is not as outdated as it counterparts in other developed countries. Most industrial property remains owner - occupied. In 1967, a special type of foncière (quoted property company) with
a special tax pass through provision known as SICOMI was established to encourage institutional investment into industrial properties. During the 1980s and the 1990s, institutional investors also used other investment vehicles such as the SCPI's and concentrated their portfolios on warehousing or multi-purpose building next to highways and airports.

Recently the industrial market has not been a very active one. There is not much interest among investors, though certain foreign investors such as Slough Estates have been active. Industrial products, however, react much faster to changes in the economy than offices. If the economy continues to grow there will be a demand for space and this demand will be for newer warehouses. This type of new high ceiling and sprinklered space is in short supply and could be viewed as an opportunity. Those areas that will come out as being more interesting will be those with good multi-modal access. Roissy, where Federal Express recently chose to build its new European distribution center is one such area because of its access to highway, rail and air transportation. Currently there are few speculative projects, most new buildings are executed as turn-key developments.

**COMMERCIAL RETURNS**

In France, returns on real estate have been traditionally low. This has been particularly true of the most sought after office product. To obtain acceptable pro-forma returns investors have assumed increasing
rents, in order to forecast capital appreciation. French rental rates are pegged to a cost index. Rents are marked to market every three years. The result of the overbuilding in the 1980s has been a decline in rents. They have dropped an estimated 30% in the last five years thus making current growth assumptions difficult to justify.

Figure 3.7: Office Vacancy Rates

With a tradition of owner-occupiers and a lack of dedicated office stock vacancy rates for office space in Paris have been historically extremely low. In the mid-eighties, even as development took off, they remained low. They stayed that way until the nineties when they quickly jumped up as new products hit the market, particularly in La Defense. In this area on the western outskirts of Paris, the vacancy rates jumped from 1.8% to 14.5% within a four-year period.

Currently, vacancy rates appear to be stabilizing within Paris. This new higher level, however, masks the true situation. Within the city there is a shift in the type of available space. The drop in rates in the Golden Triangle reflects the take-up of refurbished space that is driving the recovery, but at the same time older space remains vacant. Given that tenants are allowed to break a standard 3/6/9 lease every three years, as market rents came down tenants moved into newer premises at less cost. This explains
why from 1994 to 1996 the percentage of new space in the Metropolitan Paris available stock fell from 40% to 25%. It also explains why La Defense has experienced a greater cycle in its vacancy rate. As a newer business district it grew the most during the boom and ended up with a higher percentage of modern premises. At the same time, rents which had increased in la Defense’ since its creation in the fifties peaked in 1991. Today, with a shift in demand for this type of premises, La Defense with its large, contiguous spaces has grown in popularity. As a result, rents, which have been falling since 1991, appear to have bottomed out and are showing sign of moderate improvement.

Rent levels in Paris have shown the same peak and trough cycle. Rents have fallen over the last five years back to approximately their 1985 level. Overall Paris rents while still trending downwards have stabilized. Rents on exceptional properties have begun to rise, as the available stock is limited. The number of new searches for space is promising particularly given the declining stock. Construction starts in 1996 were the lowest in over five years. Of the projects undertaken in the last couple of years almost all were projects that were put on hold when the market crashed. Real estate professionals have expressed concern that this will cause a shortage of new large spaces.
This take-up of space should eventually start to show up in the yields or capitalization rates. Over the last five years the yields have been increasing. Overall during this period rents have fallen about 30% while property values have fallen about 50%. This has been the driving force in this yield increase. For the first time in over ten years the prime office yields are above both the long and short-term interest rates.

Overall with the maturing of the office market, real estate values are likely to become more cyclical. This last crash was essentially the first real down turn in the French market. Liberalization of capital will
continue and the development cycles will parallel more those of other major world centers such as New York and London. The fact that central Paris remains the favored French location and that development there will always be more difficult to undertake will dampen the overall cycles.

The mid-nineties retail market in France is the sector where foreign investors first became interested. Lower per capita shopping area and the law restricting new supply have spurred the interest of the English and the Dutch who have been actively pursuing opportunities. In terms of yields, retail numbers have been higher than the office numbers. Like office yields, they increased as the property market crashed. They stabilized in 1993 and have remained constant at about 7.5%. This stability combined with the restricted supply of new large spaces has made retail an attractive investment.

Other factors are also making this sector more attractive. General household spending is expected to increase 2.4% in 1997, the largest increase since 1987. Retailing also experienced a shift to larger, fashion chains such as the Gap or Zara, (a Spanish clothing retailer). This has driven the demand for large spaces. With strict new government regulations, it is becoming more difficult to find space. This has caused prime location rents to go up, secondary location rents to stabilize and has increased the
overall returns on retail property. This improvement should continue because the Socialist government is expected to stimulate consumer demand. This will help retailers and drive up demand for retail space and subsequently rent levels.

The French industrial market when compared to the US and UK is a young market. It is characterized by a high percentage of owner-occupied facilities. Industrial investment yields have been reaching into double digits. They are the highest of the French market. As companies around the world undertake corporate restructuring, they become less willing to own real estate. This concept, still in its infancy in France is beginning to have an effect. Given this fact and the low interest rates, warehouses can provide opportunities with very attractive returns. As of yet, the market does do not have activity, particularly in speculative projects. Construction starts, which were at their lowest in ten years in 1995 have more recently picked up. Absorption of warehouse space in 1995 was 1.1 million m² (11.8 million SF). New

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11 Source: INSEE, Les Echos
warehouse construction totaled 366,000 m² (3.9 million SF) in 1996. In this period, vacant space decreased from 1.5 million m² (16 million SF) in 1995 to 1.2 million m² (12.9 million SF) in 1997.

While vacancy and overall rents have stabilized, these numbers mask a very high percentage of obsolete space. Many spaces do not fit modern physical requirements, but they may have acceptable locations. At the same time, because of the extensive transportation nodes in the Paris region, there is a shift in the Paris area away from manufacturing to distribution. Competition, however, is being offered from those communities in the vicinity of Metropolitan Paris who also benefit from well-serviced transportation networks but where the availability of land is greater. When considering opportunities in this market, the demand shift and stock obsolescence have created a particular niche but it should be noted that the shorter life expectancy of this property type increases the impact of the 19% registration taxes.
CHAPTER 4: ANALYSIS OF THE MARKET

THE CURRENT STATE OF THE MARKET

The French real estate market is in a state of flux. After a long dead period, prices have fallen and the market is beginning to show signs of activity if not recovery. The residential market has experienced increased activity, in part, the result of government incentive programs. It is, however, the commercial market that manifests characteristics of change on all fronts: tenants, landlords, values, rents. Coming out of its first crash, this new reality reflects a maturing market that exhibits a stronger correlation of value related to both demand for space and availability of capital. The French market is developing the same cyclical behavior that American markets have shown for many generations. In parallel to these changes in the market structure are changes in the fundamentals of investment decision making. They increasingly rely on discounted cash flow (DCF). These changes create an opportunity for Americans who already understand how to account for the cyclical market dynamics and how to discount their effects into investment decision making.

The gradual adoption of discounted cash flow (DCF) analysis for real estate means that the impact of interest rates is better understood. Values obtained by discounting revenues stream are now benchmarked against other investments using DCF. Low interest rates are making French real estate investments more interesting at this time but they are also tying the French market to global conditions that in turn affect interest rates. This globalization means that the French financial institutions are forced to slowly abandon their old habits of sweeping problems under the rug. The greater reliance on public markets is making companies more accountable to share-holders. Though still riddled with cross-ownership, the financial cushions that companies once used to underpin failing operations are becoming more transparent.
Demand has changed as well. Tenants now require much more sophisticated space. Technology is driving industry restructuring. New office space has to meet much higher criteria than older stock. Tenants are requiring flexible space, modern climate control, state of the art telecommunication networks, flexibility in layout design and lower cost per square meter. While many of these requirements seem obvious to the American investor, they have a novelty in the traditional French markets. The French, however, have been quick to understand the importance of these technical requirements and are already meeting these needs in new office projects. In Sari’s (Compagnie Générales des Eaux’ development arm) project at Faubourg de l’Arche in La Defense, each light and air vent is individually adjusted by remote control to allow each work space to regulate its own environment, while a columnless space and plaster ceiling allows unlimited interior flexibility.

The physical requirements are not the only ones to change. As the responsibility for real estate passed to financial directors it became another line item in the budget. Previously in France, only rent per square meter counted and landlords were able to pass through any maintenance charges. Now the total cost per meter is monitored and tenants are comparing alternatives on this level. For owners this has meant analyzing cost-benefit of equipment and maintenance expenditures up-front. More importantly, it has meant that good property management has become essential. A component of French property markets that is still in need of much re-engineering.

This need is not illustrative of a strong economic demand shock. Unemployment in France remains close to 12%. This high figure is not likely to change in the near future. Companies continue to reorganize their corporate structures and the current office demand is more a criteria shift. As new office product fills, older space is vacated.

After years of avoiding the inevitable, French companies have begun to see the need to restructure. Organizationally, it has meant corporate re-engineering. In real estate, it has meant finally recognizing a decline in property values. After seven years of avoidance, owners are beginning to understand the true
value of their assets and are now starting to write them down. The creation of special “ring-fenced structures” to hold distress assets off the books has helped parent companies to rearrange their financial constraints. This recognition of the decline has allowed values to fall. It is this decline that is now attracting foreign investors. The market appears to have bottomed out. No one can say with certainty which side of the trough it is on.

France is not the only market in Europe showing these signs. Italy and Spain also appear to have bottomed out. However, France has more market size and clarity, as well as a stable political environment. Its most redeeming feature is that the financial situation of French institutions mirrors that of the US in the early nineties following the Saving and Loans debacle. There are a large number of French institutions with non-performing real estate assets and loans that want to recapitalize. There is a fundamental difference though between the American and the French situations. In the US, the federal government established a mechanism in the form of the Resolution Trust Corporation (RTC) to deal with the problem. In France, the government wants the financial institutions to resolve the problem. Even though there is little political will to make it happen, financial institutions have begun bulk sales of portfolios without any French government initiatives.

The market for portfolios has been a slow cycle of opportunities. There are only a limited number of buyers and few sell side advisors. Lazarre Frère and Banker’s Trust have been the most active to date. Responding to the fact that there are so few buyers, only one major portfolio is coming to market at a time. This allows buyers time to prepare bids. The due diligence process is more demanding in France because there is a huge gap in the availability of good information. Bidders who expected to get computerized data are more likely to get boxes of papers and no rent rolls. With the 3/6/9 lease, it is possible that there are no recent leases.
At this time the distressed French real estate market is estimated to be as high as FF300 billion. There is an estimated FF20 billion of foreign capital interested in acquisitions\textsuperscript{12}. In essence, there is little money chasing too many deals. The Americans have entered the market with the attitude of watch and learn how it is done. They are interested in turning around deals quickly and expect things to move at the same pace that they are used to at home. Attitudes are different in France. The French are more interested in the quality of life than the quantity of business. But, the market is changing. It is becoming more professional and the French are quickly learning how to play the game. In contrast to the Americans, certain Europeans see the current readjustment of value in the market as more structural than economic and believe that there will not be the same robust recovery in Europe as was seen in the States. This limits the upside of the exit strategies.

\textbf{WHY IT IS IN SUCH A STATE}

The French market finds itself in a similar predicament to the American market in the early 1990’s. A dual shock of financial deregulation and strong demand for office space through the late eighties lead to tremendous activity in the development industry. This created an oversupply that came on-line at the same time as the economy fell into a recession. Added to these shocks were the fact that development in France was financed with floating rate, short-term credit. In the early nineties, the increase of short-term interest rates raised the carrying cost of the development projects and developers buckled under the burden.

Deregulation was a response to liberalization in other financial markets, London’s in particular. The French government recognized that to prevent outflow of capital from Paris to the deregulated London market it would have to open up the French market. Much of the demand for real estate grew out of this

\textsuperscript{12} Institutional Investor, December 1996
financial deregulation. This ‘little bang’ caused a sharp rise in the demand for modern space such as trading areas. Deregulation entailed a strong growth in auxiliary services: IT specialists, auditors, publicity agencies, etc. In all about 200,000 new positions were created between 1985 and 1990. Of those, 150,000 came between 1987 and 1989. As demand grew prices on existing space ballooned and yields declined. This in turn fueled a tremendous growth in office space. Between 1985 and 1995, 15 million m² (16 million SF) of office was added. That accounts for about 37% of the 40 million m² (430 million SF) of office stock currently available.

Deregulation not only fueled demand for office space, it impacted the state of the market in a manner similar to deregulation of the Savings and Loans in the US. Until the mid-eighties the French banking sector had been a protected industry. By law, French banks were obliged to provide free checking accounts. In exchange, they did not have to pay interest on these accounts. The only interest bearing accounts banks managed were savings accounts that paid out very low returns. This provided a tremendous pool of cheap capital.

Deregulation forced financial institutions to compete for savings. They began to offer new savings vehicles at higher yields. The SICA V (Société d’Investissement à Capitale Variable) or open-ended unit trust was the perfect example. As people transferred their savings into these higher yield vehicles, financial institutions began to offer different SICAVs. These “mutual funds” invested in money markets and bonds, then later equities as the stock market took off. The competition for savings forced banks to raise the interest rates even though they were earning the same returns on their existing loan portfolios. This strained interest rate margins and forced banks to find higher yield investments to cover their increasing cost of capital.

In searching for higher yielding investments banks saw real estate as the perfect opportunity. It had traditionally been a very stable market. With the increased demand for space, prices rose creating opportunities to make good returns. In the beginning things went very well. Real estate profits
accounted for an important part of banking profits. Financial institutions could not get enough real estate deals. To attract projects, loan to value ratios went up. Financial institutions even took some equity stakes. Between 1985 and 1990, the market became so overheated that the yields on prime office dropped to 4%, 5% lower than government long bond rates of 9%. Investors believed that there would be substantial capital appreciation.

Deregulation not only forced banks to compete against each other but it also changed the rules. The 145-year-old, privately held bank, Crédit Foncier de France (CFF) is a good case in point. It had a monopoly on subsidized loans for low-income housing (PAP loans) which ended in 1989. To survive the bank diversified. It lent to property developers for ambitious commercial projects at the peak of the market. In 1996, CFF was forced to take FF13.6 billion in provisions. This raised its losses to FF10.8 billion, the bank became technically bankrupt and had to be bailed out by the government.

The CFF debacle is representative of the outcome of financial institutions foray into speculative real estate. They bet heavily on real estate by providing financing and taking equity stakes as co-developers. Those with the largest exposures included banks, Crédit Lyonnais, and the insurance companies, GAN and UAP. Crédit Lyonnais as part of its massive expansion plan issued a phenomenal amount of debt. These loans allowed the Crédit Lyonnais to increase its asset base and satisfy its capital adequacy or reserve requirements. Under the 1988 Basle Committee on Banking Supervision banks reserves were increased. They were required to maintain an 8% risk adjusted reserves (Cooke’s Ratio). The problem faced by Crédit Lyonnais and most of its competitors who invested in real estate was that if after the initial crash they had written down or sold their loans at discount they would not have satisfied Cooke’s Ratio and would have subsequently been technically undercapitalized.

The implication was that the already thinly capitalized French financial institutions were unable to quickly absorb their non-performing loans and property. Real estate values were recorded at the peak of the cycle. They have been slow to write down the difference. This has created enormous conflicts
between balance sheets and market values. The gap was so enormous that it created a resistance to sell. And, with the pervasive cross-ownership there has been little pressure from shareholders to do so. They have preferred to keep it hidden. The French were hoping values would rebound and naturally correct the problem. That is why it took so long to start to see sales of financial institution owned real estate portfolios. It has been almost seven years since the crash and although financial institutions have written off FF150 billion of loans and assets, they still hold up to FF236 billion of distressed property exposure on their balance sheets\(^{13}\).

Another aspect preventing rapid liquidation is that real estate is still seen as “La Pierre” and institutions are reluctant to sell it. They still view real estate as a long-term investment with expectations for reasonable returns on equity. Even the more fiscally prudent and stable BNP (Banque Nationale de Paris) and Compagnie de Paribas have not been willing to sell off problem real estate holdings. BNP has FF13 billion, of which 52% is non performing and Compagnie de Paribas has FF16.5 billion, of which 65% is non performing. Both preferred to report lower yields when rents started to fall rather than reassess the asset value of their portfolios. Lowering yields allowed them to camouflage losses and wait. This explains why there have been few deals to date.

**What is changing:**

The French market remains a very complex and non-transparent market. It remains difficult to track transactions as there is little public information. But the arrival of the current wave of investors, particularly the Americans, has started to bring about change. Valuation techniques are beginning to incorporate discounted cash flow analysis and sellers are beginning to accept the need for better documentation. Real estate is being perceived as more of a capital asset and less of a special asset. It is

\(^{13}\) Source: Institutional Investor, December 1996
still too early to tell whether this shift is widespread. The sale of distressed property is a sign of this new maturity. Even without a governmental vehicle like the RTC, the market is beginning to clear by itself, albeit slowly.

One thing is for sure, structurally the economy is changing. The government is recognizing the role of public markets, but overall the country has not yet undergone the modernization of government and industry that the US and the UK have in the last decade. There is still a reluctance to accept the reality of a global market but the consolidation of France into an economic Europe will lead to continued liberalization.
CHAPTER 5: WHO HAS BEEN ACTIVE IN THE MARKET

Through the early nineties, investment levels in French real estate fell. In 1994, they rose back up but three big shopping center deals, sold to the Dutch mutual fund Rodamco and the French property company Unibail, accounted for 50% of this market activity. As it stands, the market seems to have bottomed out in 1995 with FF3.1 billion in investment by major players. With FF12 billion of this type of activity in 1996, it appears the market may have turned around. This is reinforced by prediction that the upswing will continue through 1997.

![Figure 5.1: Total Annual Flow of Funds into Real Estate Assets (by Principal Institutional Investors)](image)

Essentially 1996, was the year when the French institutions finally decided to sell off portfolios of non-performing real estate. As such the product category that attracted the most attention was the sale of non-performing real estate loan portfolios to American based investors who had already played the distressed real estate market in the US.
The Germans are one investor group that still has not made a significant presence in the French market. With a recession in Germany the opportunities at home are limited. They have been focusing their activities to date in the English market where they have been active in London’s financial district. Legal requirements at home that restrict them from investing in property companies have prevented them from coming into the French market because most French real estate is held in single purpose companies. This law is expected to be changed in the near future and raises the possibility of German investment into France. For Germans, the French yields offer higher returns than yields in Germany.
Among the French institutions, the more active players in the market are the real estate companies or *foncières*. Mergers and acquisition activity is increasing as the better run funds and companies attempt to build an economy of scale. In 1996, Simco and GFC, both public companies announced that they wanted to increase their market capitalization to exceed FF10 billion, up from FF7 billion and FF3.5 billion respectively. These market plays are not restricted to traditional activities. Unibail, the quoted property company, recently created a fund to invest in distressed real estate.

The primary problem with the French distressed property market is that considering its potential size, there have only been a few transactions. As well, institutions that have decided to sell off portfolios are changing strategies. When the sales started about two years ago, sellers were willing to part with whole portfolios. Today they better understand the process and are looking to sell the revenue producing assets separately.

This has created a two-sector market. First, is the auction market where large portfolios of distressed assets and loans are being sold to opportunistic funds run by US investors. Second, is the negotiated market where primarily foreign investors are purchasing prime assets for portfolio diversification. The Dutch, English and Canadian institutional investors are the most active in this market. There is also a small market for negotiated deals of distressed property. The advantage of these smaller transactions is that they receive less attention and offer promise of higher returns.


**Buyers**

The buyers are divided into two categories those who are seeking opportunistic returns in distressed portfolio deals and those who are looking for longer term investments, purchased at the bottom of the market.

**Lasalle Partners:**

This US based firm has been active in the French market through the nineties. It was the first to purchase in conjunction with Lehman Brothers and Cargill a distressed property portfolio from the UK based Barclay's Bank. In partnership with the French bank, Société Générale, it has set up a property management company. While still active in the market, it is more interested in negotiated deals than the larger auction market.

**Goldman Sachs:**

This US based investment bank has been the most active in the purchase of distressed property portfolios. Through its Whitehall Street Limited Partnership it has purchased three of the five main portfolios. To work out the properties it has hired local talent and has set up its own property management company. It has developed a solid understanding of the French market and will continue to be an active player in the distressed market. It is also looking in other sectors of the market. It has teamed up with Westmont Hospitality of Houston to buy of a portfolio of hotels with 2,800 rooms from Crédit Lyonnais.
RODAMCO:

This Dutch fund has been active in the purchase of real estate assets. It has been primarily purchasing shopping centres across France. Though it is a global player, as a European investor, it is more comfortable with the structural characteristics of the French market.

STANDARD LIFE:

This English insurance company has been actively purchasing office properties in Paris. In 1995, its purchases accounted for almost 20% of all commercial investment property transactions.

UNIBAIL:

Unibail has been the most innovative of the foncière or property companies. Like other French property companies such as Sefimeg, it has been purchasing real estate assets. Its distinctiveness, however, comes from a recently set up FF5 billion fund to invest in distressed French real estate called Crossroads Property Investors. It is based in Luxembourg and is the first French managed fund for foreign institutional investors. Unibail will hold 20% of the fund and will manage it, and unlike traditionally French property companies it intends to use leverage.

SELLERS:

There are two types of sellers in the market place. There are the large financial institutions that are trying to recapitalize their organizations. And, there are the developers and property owners who are overextended and who want to clean up their balance sheets so that they may undertake new projects.

COMPAGNIE GÉNÉRALE DES EAUX (CGE):

This utilities and holding company has a large real estate division (CGIS) including a development arm.
It lost between FF6 billion and FF 7 billion on real estate in 1995 alone and has also been an aggressive seller of properties and projects particularly in La Defense.

**UAP-AXA:**

This merger of two large insurance companies is restructuring its operations. The company has approximately FF70 billion of real estate assets and loans. It has already started to sell off assets and loans. Given that the new chairman has publicly stated that he does not like real estate, the pace of disposition could accelerate.

**GAN:**

This state owned company has been under pressure from the government to get its books in order so that it may be privatized. It has a FF13 billion portfolio, 52% of which it has already written down in the form of provisions. GAN has established a defeasance structure for its real estate assets, known as Baticrédit. This sub-company is currently going to market with a portfolio of about 77 assets. Originally this portfolio had debt but Baticrédit chose to work out the loans itself and sell the re-positioned assets instead. They are represented by Banker’s Trust and are targeting primarily American opportunity funds.

**CREDIT LYONNAIS:**

This bank is representative of the decline of the French real estate lending market. As a result of its aggressive growth policy in the late 1980’s, it is heavily exposed to real estate as well as other high risk lending ventures. It has repeatedly returned to the government for more capital to allow it to weather the storm. It competitors, French and European are opposed to any more help. As part of its restructuring, the Consortium de Réalisation (CDR) was established as a defeasance structure to hold the non-performing assets and loans so as to protect the parent company and allow it to recapitalize. CDR
originally had FF135 billion of assets and included such diverse investments as MGM Studios in Hollywood. The real estate branch, CDR Immobilier, has a total of FF50 billion in real estate of which FF18 billion is in property loans.

**COMPAGNIE DE SUEZ:**

This old financial company aggressively lent to real estate developers in the late eighties and has been the most aggressive in term of disposing of the problem. They have lost an estimated FF27.5 billion in real estate since the early nineties. In July 1996, Gérard Mestrallet, the President announced a plan to unload over a five year period, all distressed real estate assets valued at FF14.1 billion. The January 1997 deal with Goldman Sachs’ Whitehall Street Fund (see Table 5.1) has essentially pulled them out of the real estate debt market

**LIST OF MAJOR SALES**

<table>
<thead>
<tr>
<th>Date</th>
<th>Seller</th>
<th>Buyer</th>
<th>Value in FF</th>
<th>Type</th>
<th>Price</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 1995</td>
<td>Barclays</td>
<td>Lehman Bros., Cargill, Lasalle</td>
<td>870 million</td>
<td>Debt</td>
<td>46%</td>
<td>First big deal 193 loans</td>
</tr>
<tr>
<td>Jan 1996</td>
<td>Crédisuez</td>
<td>Whitehall</td>
<td>775 million</td>
<td>Debt</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>June 1996</td>
<td>UAP</td>
<td>Whitehall</td>
<td>3.2 billion</td>
<td>Debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec. 1996</td>
<td>CDR (Crédit Lyonnais)</td>
<td>GE Capital</td>
<td>1 billion</td>
<td>Debt</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Jan. 1997</td>
<td>Crédisuez</td>
<td>Whitehall</td>
<td>4.4 billion</td>
<td>Debt</td>
<td>FF3 billion</td>
<td></td>
</tr>
<tr>
<td>Date</td>
<td>Seller</td>
<td>Buyer</td>
<td>Item</td>
<td>Price in FF</td>
<td>yield</td>
<td>Note</td>
</tr>
<tr>
<td>-------</td>
<td>-------------------------</td>
<td>-----------</td>
<td>-------------------------------------------</td>
<td>-------------</td>
<td>-------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>1994</td>
<td>Indosuez</td>
<td>Unibail</td>
<td>Shopping centre portfolio</td>
<td>3 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>Ull</td>
<td>Rodamco</td>
<td>Shopping centre portfolio</td>
<td>1.5 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>Credit Lyonnais, Nippon Life</td>
<td>Unibail</td>
<td>Shopping centres</td>
<td>750 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>AXA</td>
<td>Standard Life</td>
<td>3 offices 1 vacant office</td>
<td>670 million</td>
<td>6%</td>
<td>Accounting for almost 20% of all activity</td>
</tr>
<tr>
<td>1996</td>
<td>GAN</td>
<td>Standard Life</td>
<td>2 Office</td>
<td>480 million</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>AXA</td>
<td>Standard Life</td>
<td>Office</td>
<td>91 million</td>
<td>7.5%</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>Pleiad (Swedish Pension fund)</td>
<td>Unibail</td>
<td>Office - retail portfolio</td>
<td>400 million</td>
<td></td>
<td>30,000 m² on Charles de Gaulle, Neuilly</td>
</tr>
<tr>
<td>1996</td>
<td>GAN</td>
<td>Unibail</td>
<td>Office space</td>
<td>400 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>CGIS (CGE)</td>
<td>Philip Morris Capital Corp.</td>
<td>ZAC Danton (Faubourg de l’Arche)</td>
<td>3.125 billion</td>
<td>7%</td>
<td>110,000 office development, with 30 year rental agreement</td>
</tr>
<tr>
<td>1996</td>
<td>CGIS (CGE)</td>
<td>Blackstone</td>
<td>Descartes Tower, La Defense</td>
<td>1.5 billion</td>
<td>8.8%</td>
<td>77,000 m² with 9 year rental guarantee</td>
</tr>
<tr>
<td>1996</td>
<td>Rodamco</td>
<td>Cegep</td>
<td>Shopping center company</td>
<td>2.35 billion</td>
<td></td>
<td>Shopping center company</td>
</tr>
<tr>
<td>1996</td>
<td>AGF</td>
<td>Sefimeg</td>
<td>La Fourmi Immobilière</td>
<td>3.75 billion</td>
<td></td>
<td>250,000 m² of primarily residential to Quoted property company</td>
</tr>
<tr>
<td>1996</td>
<td>Macif</td>
<td>Hines</td>
<td>50% of Trema</td>
<td>1.5 billion</td>
<td></td>
<td>Largest shopping center developer owner, in France, Italy and Spain</td>
</tr>
<tr>
<td>1996</td>
<td>CGIS (CGE)</td>
<td>Caisse de dépôt et de placements du Québec</td>
<td>Tour Pacific</td>
<td>undisclosed</td>
<td>Office building at La Defense,</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>CGIS (CGE)</td>
<td>SITQ (Caisse de dépôt et de placements du Québec)</td>
<td>5 towers &amp; one option</td>
<td>4.2 billion</td>
<td></td>
<td>Five towers and options to build sixth at La Defense Largest property transaction in many years</td>
</tr>
</tbody>
</table>
CHAPTER 6: OPPORTUNITIES

Investing in French real estate presents opportunities. It appears the prices have bottomed out and are showing signs of recovery. This reprise must be taken within the French economic context. Still troubled by high unemployment and persistent public deficit it is unclear at this time how strong this economic recovery will be. This risk is further exasperated by an uncertainty in the direction that France will be taking with its new political masters. Since taking office in June of this year, the Socialists have sent mixed signals to the market. They are advocating more interventionist policies yet demonstrating a willingness to continue the liberalization of the French economy, both on a financial plane with continued privatization and on a social plane with the possibility of reopening private pension schemes legislation.

France’s determination to work within the guidelines of increasing European unity will also help tame any large deviations of planned market reforms. The pressures of a single European environment will bring fiscal structures in line with that of its neighbors. This will make investment for other European investors easier and fiscally more attractive, particularly given that the adoption of a single currency will remove any currency distortions in returns.

For real estate, this economic climate has two implications. Firstly, with a recovery underway, even if not strong, there are certain product types that will be attractive as investments. This will drive interest in both the development and purchase of these assets types. Secondly, the fact that the financial restructuring of the economy will continue, the pressure on the large holders of non-performing real estate to work out their problems will persist.

The French market offers possible real estate investment opportunities at this time. There is, however, a large caveat to playing in this market for Americans: the importance in distinguishing between
opportunistic investment and long-term diversification investment. The American investors who have been major players in this market for the last two years have been seeking opportunistic ventures. While these may offer interesting returns, these vehicles are fraught with the same structural problems that affect the overall French market such as the 19% registration tax.

The French market is substantially less liquid than its American counterpart. Information is less transparent and the underlying tenet of ownership remains different. This French belief in “La Pierre”, skews market values by adding a premium Americans are not willing to pay. But, it can also play in the American’s favor as a timing issue. French institutions, because of their cultural attachment to property, could be tempted back into the market in the future. And this could represent a possible exit strategy for those investors who are now entering the market.

Signs of recovery are visible in certain niche markets. The prime, new office building is the best example. There are at this time a limited number of buyers who have access to capital in the market. These limited resources reduce the marketability of property and hence market value. This situation will not persist. As French companies regain their financial strength they will once again consider the purchase of real estate. While they may not be as keen as they were in the late eighties, there should still be an attachment to the tangible assets. Real estate professionals estimate this window of opportunity to be about eighteen months long.

Of the different real estate product types, Class A office is particularly interesting as an investment because of the endemic supply constraints. The regulatory environment and the limited access to premier land implies that when demand will begin to rise, there will be pressure on the rents and subsequently the values of these Class A properties. The demand for this space type is already present in the market, but it remains a cyclical play. As more assets get sold off, prices should find their appropriate levels. The conditions in the leasing market are sound. Demand is picking up and rent concessions are going down. If one looks at the ten year trend of yields, rents and volumes of
transactions, there is no doubt the oversupply is slowly being absorbed. In 1993, 75% of available office space in Metropolitan Paris was new, now that figure is down to 20%. The prime office market is approaching its equilibrium vacancy of 7%. If demand for prime space pushes vacancies to 3-4% there will be pressure on rents and subsequently prices.

The flaw in this opportunity is that demand is not new. It is a shift out of secondary properties into better, newer ones. The positive absorption in this property type means a negative absorption in the older stock. It is this shift that is pushing the development of a two tier market. The growth potential of the lower tier is severely restricted. Only well located buildings will provide re-development opportunities. It is highly unlikely that there will be any strong demand shift for these second tier properties. Unemployment remains a constant problem and even though there is growth in the economy it has not had any major effect on employment growth. Without this growth, the overall demand for office space shall remain constant.

Though it shows the best promise, office real estate is not the only opportunity in France at this time. The residential market has some particular opportunities. For American investors, long-term investment in residential real estate does not offer the type of returns they are expecting. French financial institutions still view residential as a stable, long-term investment and accept lower yields. With low interest rates, though individual ownership of apartments has become more attractive and unit by unit sales are providing a 20% gain over bulk sales. There is, therefore, the opportunity to arbitrage the price differential, by purchasing or developing buildings and selling off individual units. This option reflects current market conditions that will not persist and as such is a short-term prospect. With the Perisol law (see Chapter 3: Residential) helping to stimulate demand, there are also possibilities in new residential development within Metropolitan Paris.

Though it is a very particular niche market, there is also demand for warehousing space. As consumer spending increases, the demand for new facilities should increase. France’s industrial stock may not be
old compared to that of other industrialized countries like England but it suffers from the same shortcomings of most warehousing space around the world. New, high capacity, automated facilities have particular requirements that can not be met within existing shells. This creates an opportunity to develop modern facilities fitting these technical requirements in key strategic locations. An extension of this opportunity is the development of third party warehousing as well as storage - delivery services. What is interesting about the latter is that it moves away from asset ownership to asset management, an area that also offers tremendous opportunity in France.

Traditionally, French institutional investors have focused on the Paris market where most commercial investment properties are located. As the French economy starts to rebound, other areas of the country will also recover and could present opportunities. While not within the scope of this analysis, it is an area that should be studied as the demand growth in secondary markets could also prove of interest.

DEVELOPMENT

Another medium in which to enter the French market is development. Even though France is still feeling the effects of being overbuilt, much of the office stock is old, outdated and does not meet tenant requirement. This conditions means that there is room to undertake the construction of certain types of new product. There is predominately a need for large contiguous space as those available are quickly disappearing. With tenants wanting cheaper overall costs, the physical building has taken more importance, even though location is still a strong determining factor. Tenants are now looking at whole cost of tenancy and not just the costs of the lease payments, which again brings up the need for superior building management.

Building in France is not obvious. History plays an important role in any architectural work. To get anything built within the city of Paris requires the permission of the Architecte du Batiment de France. This government employee determines whether a project can go ahead. It is particularly important when
creating in-fill projects. It is the role of the *Architecte du Batiment* to determine how much of the existing structure must be preserved. In some cases, he will require that sections of the original fabric of the building remain, and these may make a modern, efficient redevelopment impossible.

Another component that is different is the impact of land values. In an American development proforma land will account for 30 - 35% of the project costs whereas in France this value is much higher. Land currently accounts for about 65 - 70% of development cost though it has been as high as 90%. This would explain why American developers, such as Gerald Hines, who are undertaking the development of major office towers have not yet purchased the land outright. They are still working off options on the land until they have enough lease commitments. This leads to another problem in developing real estate in the French market, the lack of capital. While there is available capital for a build-to-suit or for the purchase of an existing pre-leased structures, financing for speculative projects is still difficult to find.

**PORTFOLIO PURCHASES OF DISTRESSED REAL ESTATE**

An important part of recent transactions in the French market have been portfolio deals. These contain performing assets, non-performing real estate loans and non-performing real estate assets. The latter two have made up the bulk of attention in the last two years. The French have fewer problem selling loans than property. It is the non-performing loans that have been the seed of much of the current interest in French real estate by US investors. Americans are hoping to replicate the transaction structure, which work so well to resolve those loans of the RTC.

From the buyer’s perspective these portfolios are heterogeneous pools, with both loans and assets. They range from loans secured by office buildings to vacant building sites. Information on the loans and assets in the pools are not as well developed as would be expected in the US. The pool of buyers, while expanding has to date been fairly limited. There have been five potential buyers: Goldman Sachs’ Whitehall Fund, GE Capital, Morgan Stanley, Brazos and the French Unibail. With more bidders in the
market for distressed portfolio, the spread between the book value and the discounted value goes down. In order to gain market experience, new players are willing to accept lower spreads. As more US funds enter the market, the Americans create their own competition. To date there have been five highly visible transactions, but there are also smaller ones going on. In these small ones there are more one on one negotiations and better overall returns. As of this date, there is only one major portfolio for sale, a 77 asset Bâticrédit sale.

Where the US investors have an edge over their French counterparts is the ability to react entrepreneurially to large transactions. Information is key to succeeding in this market place. Competitive advantages are made in the due diligence process. It is important for bidders to understand the true cost and time frame of reorganizing the portfolios. The typical exit strategies for these portfolios involved several vehicles. In the US, the opportunity funds have sold back loans to the borrowers, foreclosed on assets and repositioned them, or have securitized the loans. In France, these same strategies while possible are not as straight forward as their American counterparts. To date, the strategies have been to start by renegotiating with the borrower. Loans are typically purchased at 30 cents on the dollar. If for example the borrower can find new financing for 50% of the original face value, the original note will be sold back to the borrower for this amount. This 20¢ profit amounts to a 67% return on investment. Of course not all loans work that well.

Working out the loan is the preferred route because foreclosure in France is a more complex and lengthy process. Firstly, the French will stop payments on their loans sooner than Americans do. Secondly, the time of foreclosure normally 12 to 24 months can run up beyond a couple of years and at the end there is no guarantee the judge will not rule in the borrower’s favor. When forced to foreclose the next step is to try to reposition the property with better management. This requires a longer period in order to get some upside to cover the foreclosure costs which can run at between 10 - 15 % of the value of the asset.
The third exit strategy, securitization is still in its infancy in France. It has only been used once to date. In 1996, the GAN subsidiary Sofal securitized FF1.5 billion of distressed commercial property loans. There were important limitations to this deal. Firstly, the securitization vehicle is not permitted to own real estate assets. To overcome this problem the deal was structured through an Irish holding company, Belenus. This company held the debt in trust for the investment subscribers. Secondly, Sofal underwrote a significant portion of the deal by keeping the D, E, and F tranches valued at FF588 million themselves. The reason for the important underwriting is that unlike in US, the credit support for the upper tranches has to be greater. The risk associated with default is different because of the longer time frame needed for recovery of assets and the greater uncertainty associated with the French tribunal decisions. Rating agencies are just beginning to develop models for the French market.

What the Americans have brought to the market is a more rigorous approach to analysis and a whole new set of understandings. They are getting the French to understand the notion of net operating income. At the same time the French are also learning how to work out their own loans and add value to the remaining assets by improving the property management and quality. The competitive advantage of Americans is their ability to understand the true cost and time frame of the market. They are arriving with their valuation templates and over-laying the French tax regimes and lease structures. These structures are more complex than in the US as different operating tax rules can apply to different parts of the same building depending on the use (retail, office residential etc.). The importance of understanding the lease structures and especially the tax rules can not be overstated. As they are a crucial component of real estate values in France, in preparing bids for portfolios, it is important to establish good legal and fiscal counsel.

Another consideration in a short-term opportunistic venture for Americans in France is the issue of currency risk. While still present for other European investors, the locking of exchange rates through EMU minimizes their risk. This is not the case for the American dollar where currency fluctuations have
a leveraging effect. They may either increase returns or totally wipeout all profits and erode capital. To protect from these fluctuations it is possible to hedge the currency exposure. Using forward currency contracts and swaps it is possible hedge the US dollar against the French francs. These add approximately 1.5% to the portfolio cost. It is also possible to create a natural hedge to protect part of the investment by borrowing in French francs. This will protect the financing costs but not the equity.

Portfolios are very interesting opportunities but their exit strategies have to be thoroughly thought out. Firstly, the time frame for this investment is longer in France than in the US. Disposition at the end must also be considered. Essentially, there will have to be willing buyers at the end of the holding period. That means that the French market must rebound such that it regains enough strength and that the French are willing to buy investment property again. The underlying economic determinant remains demand. There is little question that for prime property demand will increase because supply is limited. However, that is not the case for secondary properties and distressed real estate tends not to be prime property. This is reinforced in France where the selling institutions have chosen to cherry pick the better assets out before the sales. This leaves a question as to the possible up side on the properties. That is not to say that it is not possible to add value. There is a tremendous market opportunity in France to create asset and property management services.

Portfolio deals are still in their infancy in France. There is a duality to them. On one hand, the French financial institutions recognize the need to reorganize their balance sheets which involves the disposal of distressed real estate assets and loans yet there is a reticence to do so. This makes existing opportunities more difficult to come by. This reticence also means that when French institutions become sufficiently strong again there will be little incentive for them to do deals. Those investors who will succeed in the market are those who understand its structure and who understand the recovery of the leasing market.
A third area of opportunity in the French real estate is the development of management companies. Their need comes from two sources: distressed portfolio management and improved real estate management. The first is to instill a knowledge base in the management of distressed portfolios. These would service and work out the loans. They would also manage the foreclosed assets, reposition them so as to add value to the property and prepare them for eventual sale. Given that the notion of distressed real estate assets has until recently never existed in France, this type of property management is non-existent. With the large volume of distressed assets, whether held by the French institutions or American opportunistic funds, this type of services will be required.

There have already been ventures in this area. One is the joint venture between the American based, Lasalle Partners and the French bank, Société Générale, called Lafayette Parternaires. A second is Finestate & Robert, a joint venture between the American, J.E. Robert Co. and the French, Compagnie Finestate. The joint venture vehicle allows the combination of American techniques and management principles with the French understanding of the local leases, markets and tax structure.

The other option is to build a new platform. Goldman Sachs has chosen to create its own asset management firm and this has turned out to be a good investment. While more difficult and time consuming to create a new platform, it does not have to deal with conflicting management issues and is free to pursue its own course. It is not a cheap alternative. It is important to hire talent with a solid understanding of the local markets and combine this with the expertise that the investor is trying to integrate into the marketplace. For Goldman Sachs, its asset management company has been an important component of its strategy to date in France.

The second reason that these types of companies present an opportunity is that the notion of the real estate asset is slowly changing. With the crash of real estate markets, the buy and hold tradition of real
estate so prevalent in France is being questioned. Buy and hold meant that properties were bought as
very long-term investments and the short-term was neglected. Within this context, property management
amounted to little more than the collection of rents. The need to continually manage the assets presents
an opportunity for Americans because the concept of optimizing value through management is well
developed in the US.

Management companies present a truly interesting opportunity. Not only do they serve the immediate
servicing needs of the large non-performing portfolio deals but they also have a natural long-term
strategy. Their ability to add value over the life of a property, means growth potential in the long run.

PUBLIC MARKETS

When comparing the US and the French market and their respective recoveries one of the principal
differences between them is that the American market’s recovery was in a great part driven by the
repositioning of distressed holdings whose prices had collapsed and by the inflow of capital from new
sources. The expansion of the tax efficient Real Estate Investment Trust (REIT) attracted equity capital
seeking higher returns. REITs were a spread investment play where low valued real estate was converted
into a public format. On the other hand, securitization of debt markets brought in much needed credit for
real estate but in exchange demanded a higher spread over treasuries. With no available capital in
private markets, real estate had to go to the public markets for capital and had to abide by their rules.

This parallel does not exist in France. Securitization is still almost non-existent and while the foncières
are publicly trade property companies, these are taxed as corporations and do not have the tax pass-
through advantage of REITs. The SPCI or real estate funds do offer this transparency but given that
there is no secondary market for their disposal, they lack the liquidity and, more importantly, the market
pricing of the REITs. With little capital coming from either French public or private markets, the main
sources of funds for real estate today is foreign capital. As the French institutions improve their balance
sheets, they will re-enter the market. Already, there is some available capital for conservative, fully leased purchases.

One reason the public market has not developed is that there is little pension fund activity in the market. State agencies prefer to invest in bonds while the rest of the industry remains too small. There is talk of pension reform but change will be difficult because the unions, who oppose change, still exercise a strong influence. This lack of US style REITs does not preclude the possibility of opportunities. The restructuring of individual companies and the generally depressed state of the public markets are providing opportunities from both a real estate asset perspective and from an investment vehicle perspective. With a lack of French interest, there are a lot of companies and funds that are trading below the Net Asset Values. This is an opportunity for restructuring, mergers and growth. When the publicly traded Sefimeg announced provisions of FF537 million in 1995, the market reacted favorably and the share price went up 15%. Paralleling the growth of REITs, there is a possibility to bring in franchise value, to not only bring the quoted market price up to market value of the assets but also to create a premium over NAV based on the franchise value of management.

**WHEN THE MARKET RESUMES**

The French market is a real estate play. Investors have to be aware and ready to take on the real estate risk and reward. It is also a medium term play because nothing is short-term in France. Part of it is structural, part of it is cultural. Domestic players are in for the long run. Stifling regulatory constraints make the cost of doing business high. The legal and tax environment is complex. Culturally, it is tough to get US style deals.

Even within this context, however, the French market is one that presents an array of opportunities for American investors. Before entering the market it is important to determine what type of investment strategy is going to be followed. France presents different opportunities for investors seeking
diversification or for those seeking opportunistic returns. In either case, the key component to making
investments in France profitable is understanding the legal and more importantly the fiscal environment.
However, it is important not to forget the linguistic and business culture differences. There is still no
transaction culture in France. The deal is not perceived as a win-win situation. People want to hold on
to real estate. This explains why selling companies are willing to give reduced interest rate, seller
financing with future upside. They are forced to sell to recapitalize but they still want to stay in the
market. On the other hand French companies, while learning from their American counterparts, have
found a certain arrogance in the American onslaught. Senior executives do not appreciate the familiarity
that Americans bring to the negotiation table.

The state of flux of the market is one of its positive attributes for Americans. It creates possible plays in
the shorter term with a natural exit strategy as French investors will probably be back in force in two or
three years. As well new players are poised to enter. The French bank - life insurance companies,
\textit{bancassurance}, have been collecting premiums for the last decade. Unlike the large insurance
companies, they were still in their infancy in the eighties and avoided real estate. They are now heavily
invested in bond and stock markets but will be looking to diversify and real estate provides a good
opportunity. All this narrows the window of opportunity for current investors. When more investors
come in to the market, pressure will be exerted on prices and the number of opportunities will erode.
Currently interest rates are the lowest they have been in over a decade and this makes a lot deals more
bankable. But just as in the US of the early nineties, it is the lack of available capital that is creating
opportunities. That is not to say that there is no capital but rather interest in real estate is still low and,
therefore, capital is still untapped.

For those more interested in longer term investment the depressed state of the market has opened up
opportunities. Though the time frame for recovery of the market is still questionable there are niche
plays. Prime, high quality, modern office space is one such play. It was one of the preferred types in the
last boom and is once again proving it can be interesting. For Americans, however, the yields compare to the bond market.

For opportunistic investors the biggest market at this time remains the non-performing portfolio market. Though it has strong parallels with the American RTC situation, there are important differences to take into account. Firstly, the US game was very much organized by the government. This is not the case in France. Much as the government is telling the financial institutions to change their ways, there is no direct political pressure to do so. Privatization programs for state companies such as GAN and Crédit Lyonnais will create pressure for these institutions to react but they have avoided tackling the problem for over five years and may continue to do so. With some inkling of economic recover, banks are hoping to be able to weather until the market picks up again.
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Aref Lahham, Principal, Lasalle Partners, Paris, May 28, 1997
Solly Gubbay, Director International Investment, Auguste Thouard Paris, June 2, 1997
Christophe Clamageran, Sous-Directeur, Meunier Promotion, Paris, June 5, 1997
Guillaume Cailloux, Manager, Greenwich Bourdais, Paris, June 5, 1997
Jonathan L. Lewis, Clifford Chance, Paris, June 2, 1997
Marie Macri, Département Expertise, Jones Lang Wootton, Paris, June 3, 1997
Patrick Albrand, Directeur, Hines, Paris, June 9, 1997
M. Stéphane Theuriau, Directeur Général, DTZ Jean Thouard, Paris, June 9, 1997

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