

European Quarterly

Market Perspective

Executive Summary

- The economic recovery looks to be long and drawn out, although some forward-looking indicators suggest that the first quarter will mark the bottom. Tenants in all sectors of the space markets are under pressure to cut costs.
- Due to rising capitalization rates, a broken lending model and deteriorating fundamentals, most markets still have a way to go before investors put capital to work.
- Listed property firms have begun raising equity to repair balance sheets, but the sector remains volatile, primarily because of concerns about fundamentals.
- Recovery in commercial real estate depends to a large degree on banks, which remain reluctant to lend and face an increase in nonperforming loans as a result of deteriorating space market fundamentals.
- Loan-to-value covenants have been breached on a large volume of loans as property values fall. Investors are looking to take advantage of opportunities created by an expected €109 billion shortfall involving maturing debt that can't be refinanced with the same level of proceeds.

Overview

Eighteen months into the global financial crisis, there are indications that the recession may have reached something of a turning point in Europe. Forward looking indicators – such as the Purchasing Managers' Index survey of business expectations – are showing signs of improvement, possibly as a result of government-led initiatives. Second-quarter economic data in Europe may improve, with the exception of the Central, East and South East Europe (CESEE) countries.

Nonetheless, since real estate is a lagging indicator, the immediate outlook for the space markets in Europe is poor. Rental rates declined in virtually all cities across all sectors in the first quarter. Transaction activity is difficult, given the lack of lending. Banks are unwilling to increase their €1.8 trillion holdings of real estate debt, which represents about 12% of their loan books. At the same time, banks are reluctant to actively manage their debt portfolios, despite property values falling by as much as 40% since the peak of the cycle, which has created a growing list of properties in breach of loan-to-value (LTV) covenants. Instead of forcing borrowers' hands and demanding capital to cover the shortfall, banks are mostly waiting for loans to mature, which delays the hard choices and distress. That masks the depth of the problem, and puts off a full recovery until the overleveraged debt works its way through the system.

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Real Estate Debt Markets

That banks have yet to aggressively manage their debt portfolios in light of widespread covenant breaches has an air of self-preservation to it. Lenders are under pressure to rebuild cash reserves, but they want to avoid reporting loan losses that would accompany liquidation. As long as borrowers pay debt-service, banks can turn a blind eye to LTV covenants and hope that property values recover before maturity. There might also be a whiff of political support for such action. The UK government has pledged backing for new bank lending from institutions in which it has full or part ownership, and neither the government nor the public seem inclined to endorse aggressive enforcement of financing terms that leads to foreclosures.

Banks that have not yet taken government backing may be compelled to relax enforcement of covenant breaches if they know that taxpayer money might help bail them out. However, government support may be a last resort because it would inevitably come with strings attached and loss of reputation. The upshot is that the lack of good alternatives will probably lead banks to avoid managing real estate debt.

In the meantime, outside of small, low-leverage loans on stable properties, lending to the real estate sector is effectively closed. Many banks – including UBS, JP Morgan, Eurohypo, HSH Nordbank and RBS – are winding down lending operations or cherry-picking the best deals with existing clients. Meanwhile, there is a growing list of banks that are receiving government bailouts. For example, the Spanish government pledged a €9 billion emergency package to rescue Caja Castilla-La Mancha, while the German government took a 9% stake in Hypo Real Estate, the nation's second-largest commercial property lender.

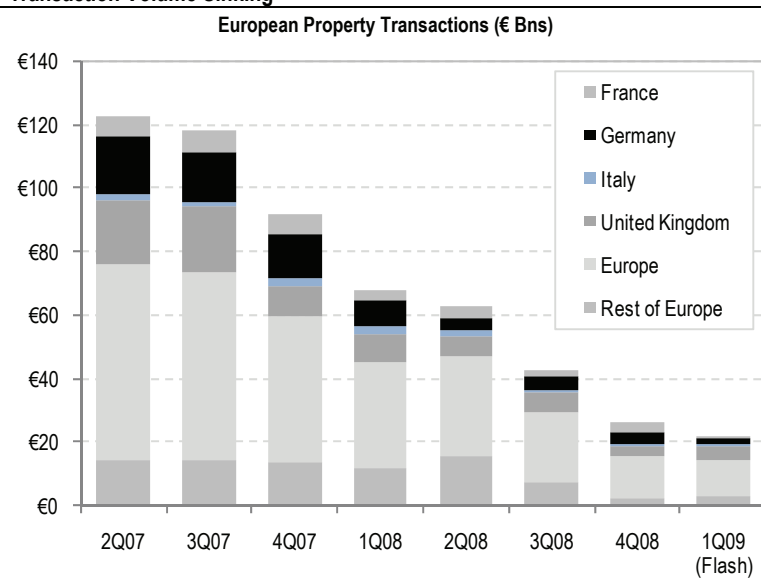
Investor Behavior

Property transaction volume in Europe was a meager €11.5 billion in the first quarter, according to CB Richard Ellis (CBRE), due mostly to the lack of debt and the uncertainty about property values. This marked an 84% drop since the peak of the boom in 2Q07. The temporary closure of the German covered bond market last October (it re-opened recently) was a big factor, impairing transaction activity in Germany.

The correction in cap rates, at least across Western Europe, has started to slow. They rose 20 bps on average across the main European office markets, to about 6.6%. At the same time, cap rates in markets across the CESEE rose by as much as 100 bps as risk appetite fell sharply.

Many investors are trying to repair balance sheets or are waiting for prices to fall further before getting back into the market. Listed property companies have become net sellers, while private equity

Transaction Volume Sinking

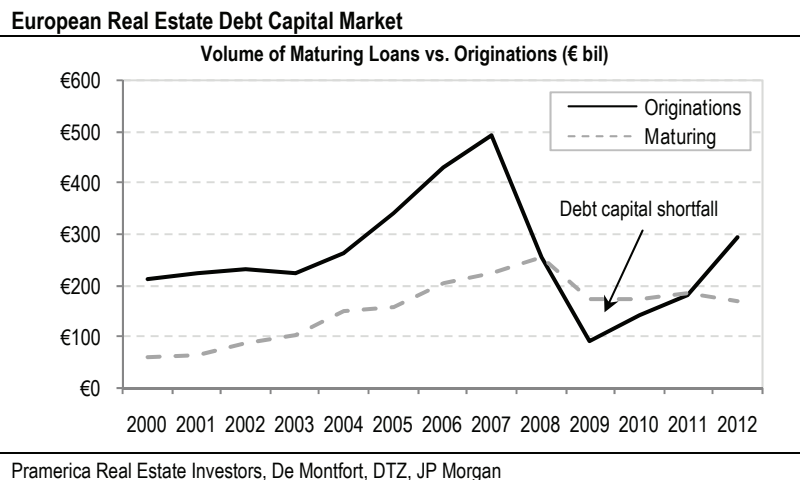


DTZ Research, Pramerica Real Estate Investors

funds have been forced to make capital calls to meet growing equity shortfalls in existing funds. However, institutional investors that are active are turning their sights to core western European markets, particularly the UK, as investors look to take advantage of the steep drop in values and the weak pound. Recent surveys indicate that investors prefer less risky markets and assets. Moreover, investors and lenders are retrenching to domestic markets. Cross-border investment flows in the direct market fell by 66% in 2008 against an overall 50% fall in direct investment. U.S. investors in particular retrenched, supplying less than €8 billion to European deals in 2008 compared with €35 billion in 2007.

Real estate investors are also turning to other forms of indirect investing. For example, UK REITs raised around €3 billion over the past few weeks to pay down debt. The rights issues were highly dilutive but investors had to participate to try and maintain the value of their existing stock. Balance sheets have become critical in differentiating between listed property firms, as investors have grown increasingly concerned about the impact of leverage on real estate portfolios. This has created a dichotomy between the “haves” and “have nots”, of those that have gone to the market earlier and successfully raised capital to the detriment of those that have yet to do so. But generalist investors remain wary of the sector. Despite talk that UK REITs might now be finding a bottom, the listed sector continues to suffer from volatility driven by poor fundamentals and lack of visibility on capital markets. The first quarter return for the euro-denominated S&P BMI European Property Index was -14.4% against a -9.9% total return for the broader European Index.

Investors are also looking at opportunities to provide debt. In recent years, banks wrote loans at aggressive LTV ratios. With property prices down and banks lending more conservatively, European property owners are likely to face a shortfall between the amount of debt that is coming due and what they will be able to procure from banks for refinancing. That shortfall could be nearly €80 billion this year and rise to about €109 billion by 2011. Already a number of high-yield funds are looking at opportunities that might arise as loans need to be refinanced.



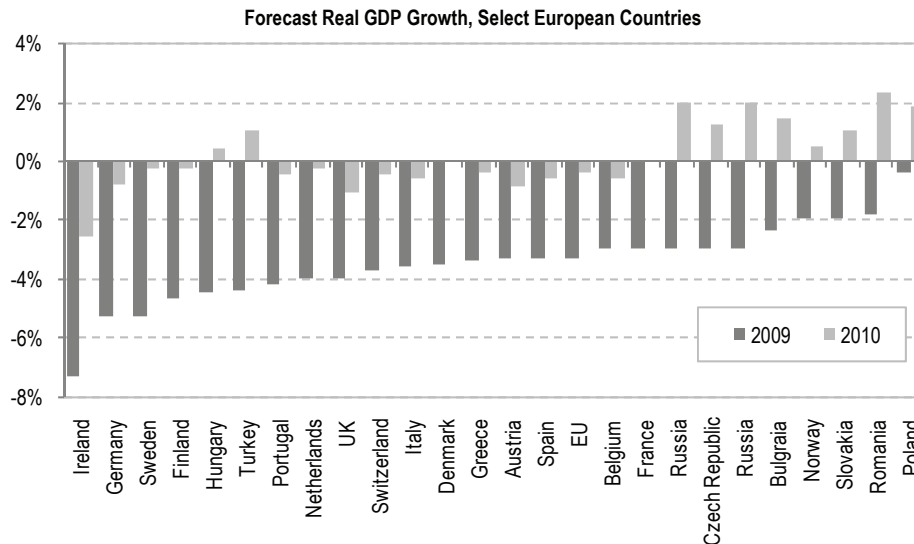
One reason why investors might favor the indirect route is that it can involve relatively small sums, as opposed to buying assets in the direct market. But it also reflects investors' lack of confidence in the outlook for space market fundamentals. Investors worry that the market still has room to fall. The nascent property derivatives market is trading at levels that indicate a drop in values this year of about 15% to 20%

in UK and French properties. Furthermore, the derivatives market is not forecasting positive property returns until 2011. So investors are inclined to wait, while the wider macroeconomic environment deteriorates and expectations for returns are revised down.

Economic Environment

Although Europe is in a recession, it appears that some markets, notably consumer-led economies such as the UK, may be ahead of the curve in terms of recovery. Export-led economies such as Germany may be headed for a long and drawn out recession because – unless they change domestic consumption behavior – they are dependent on recovery elsewhere around the world. Every economy across Europe is now expected to shrink in 2009. Nonetheless, the latest forward-looking indicators, such as the PMI survey, suggest that GDP growth for the EU27 might have hit the bottom in the first quarter, suggesting that policy measures such as stimulus packages and bank rescue packages are working. There is still a danger, however, of overdoing the outlook and translating “less bad” into “getting better.”

Negative GDP Growth Rates Expected



Pramerica Real Estate Investors, Economist Intelligence Unit

The current downturn is a serious test for the 16-nation eurozone. Some member countries are reporting poor economic data that may require painful wage and cost adjustments. National debt-to-GDP ratios are rising significantly in some European countries, prompting ratings agencies to downgrade Greece, Ireland, Portugal and Spain since the start of the year. Across CESEE, however, this downturn is a bigger test. Three governments have already been toppled as financial markets have plunged and economic growth faltered. The recently announced increase in funding to the IMF has helped steady the markets to date.

Space Markets

The sharp slowdown in economic growth over the past two quarters is spilling over into the space markets, which tend to lag changes in the economy. Net absorption and headline rents fell in all major European

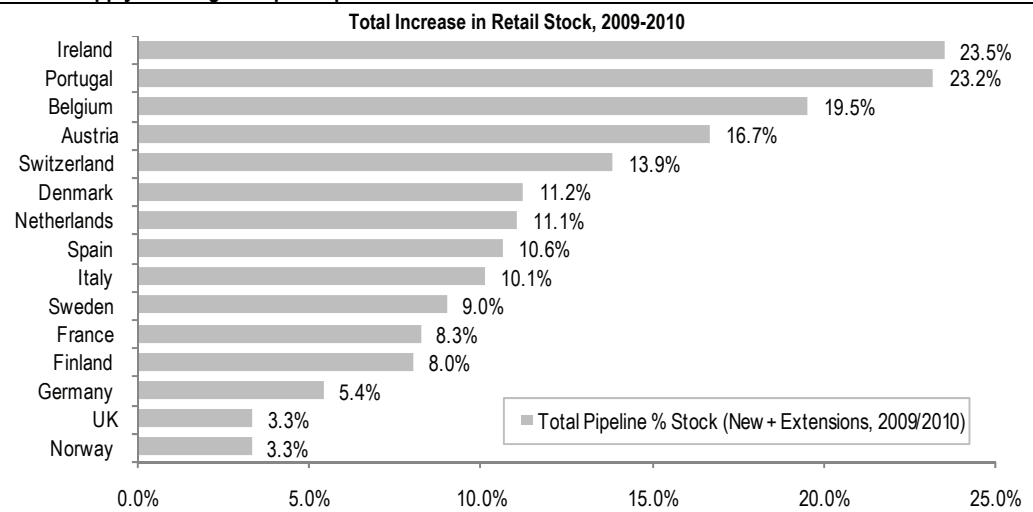
cities and all property sectors in the first quarter. Tenants are under pressure to cut costs and rationalize operations as the recession continues.

Office. The details vary at the market level, but the basic story is the same. Tenants, particularly financial firms in Western Europe, are relocating from expensive central business districts (CBDs) to cheaper non-CBDs or to new open-plan offices. An increasing amount of sublease space is becoming available, in line with falling employment. Pressured office landlords are offering aggressive incentive packages and are willing to renegotiate leases. There are some exceptions – a lack of high-quality space in the CBDs in cities such as Berlin, Brussels, Lisbon, Luxembourg and Milan has kept headline rents broadly unchanged.

The development cycle is slowing, although roughly 3.8 million square meters (40.9 million square feet) of space – 2.5% of office stock – is due to come on-line in 2009. If forecasts for the loss of 200,000 service sector jobs in the EU27 in 2009 and 2010 are correct, that would produce an extra 6.5 million square meters (70 million sf) of vacant office space. Some cities will be worse off than others. Large increases in new supply are expected in London City, Dublin and Madrid in 2009, which is why rents are falling in those cities. Rents also will likely fall in CESEE markets, where net absorption is expected to lag supply.

Retail. The development pipeline may be at more risk in the retail sector. According to Cushman & Wakefield, about 17 million square meters (182 million sf) of shopping center space is due to come on-line in Europe this year and next, which would produce a 14% increase in total stock. The increases are huge in parts of the CESEE, reflecting a push toward modernization, and in other small western European countries. However, the downturn will likely impact retail values in all sectors, as landlords aggressively market space.

Retail Supply Growing at Rapid Clip



Pramerica Real Estate Investors, Cushman & Wakefield

The collapse in the credit markets also plays a part in the retail sector outlook. Not only are consumers saving more, they no longer have access to the generous helpings of bank credit that were available in recent years. Meanwhile, the reduction in home sales has cut into demand for big ticket household goods. The outlook for retail is also tainted by the slowdown in globalization, with a number of high-end retail chains increasingly looking overstretched. To date, secondary high street and retail warehouse sectors are

reporting the sharpest declines in net absorption. On a geographic basis, rents are falling across heavily indebted countries such as the UK, Spain and Ireland, and they are showing signs of deterioration across the Nordics and CESEE.

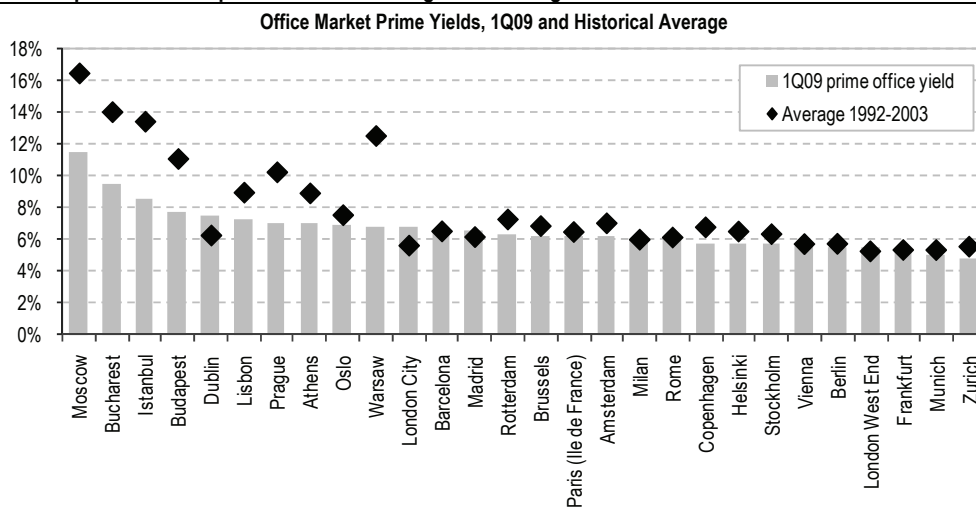
Industrial. The outlook for the logistics sector is similarly poor. The collapse in export orders and industrial production resulted in declining rents across the periphery of Europe. Only core western European economies appear to be holding up, with the exception of cities in the UK and Paris. With higher labor costs and reduced sales volume putting a squeeze on profit margins, tenants are struggling to keep costs down, putting downward pressure on rents. Manufacturers are trying to address excess capacity, while distributors have been actively trying to secure efficiency gains down the supply chain.

Industrial rents are also under pressure from a relatively large amount of new space that came to market in 2008. According to Jones Lang LaSalle, 10.7 million square meters (115 million sf) was completed last year in Europe, which added 12% to total supply. The imbalance has yet to produce falling rents, but it could. Industrial rents should hold up in key urban locations and key seaports, as well as in Europe's peripheral markets, where there was a need for modern space that offers operational efficiency and transportation cost savings. Elsewhere, though, rents will likely continue to fall as vacancy rates rise and as occupier demand is increasingly dominated by firms that focus on staples or non-discretionary goods.

Real Estate Values

It remains unclear how far cap rates will rise before the market finds a bottom. Investors are understandably cautious about the economic outlook and the prospect of changes in the space markets. If cap rates revert to long-term averages that pre-date the era of excess global liquidity, some markets still have a long way to go before reaching equilibrium. And that is true even if one assumes reduced risk premiums in emerging markets. Many investors are likely to sit out 2009 because of the anticipation that property values will drop throughout the year. Investors that do plan to deploy capital this year are focusing on core properties in high-end locations, such as the UK.

Office Cap Rates in Europe Remain Below Long-Term Averages



Pramerica Real Estate Investors, CBRE, Cushman & Wakefield

Closing Thoughts

Sentiment toward European real estate continues to remain poor as banks restrict lending and the space markets weaken. It is clear that cap rates in some markets have been slow to adjust, compared to markets such as the UK, and therefore values are likely to keep falling. Property transactions will be stifled by the large gap in bid-ask spreads and a lack of appetite from investors, who are focusing on repairing their own balance sheets or deploying capital in indirect sectors.

Although distressed asset sales remain surprisingly few and far between, we expect the volume and velocity of distressed deals will pick up over the balance of 2009, as more owners face debt and equity shortfalls and as fundamentals deteriorate further. All eyes will be on banks, whose strategies for dealing with the €1.8 trillion of European real estate debt they hold will shape the performance of the sector in coming months and years. Banks by and large could take a firm stance with borrowers and force compliance with covenants or they could roll over loans and push the problem into the future. What they choose to do will determine the length and depth of the investment cycle.

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