

European Quarterly

Market Perspective

Executive Summary

- Economic growth is set to improve in the second quarter following a raft of weak economic data. But risks abound, including Greece's ongoing debt refinancing saga. Central banks remain committed to offering easy monetary policy for some time.
- The manner in which banks will manage down their estimated €1 trillion loan book is a key to the direction of the commercial real estate market. Banks have offered little clarity to date, which means a long and drawn out solution remains likely.
- Overall sentiment has improved, but most investors and banks remain focused on prime real estate in core markets. Nonetheless, there are signs that investors are starting to look further afield than major prime markets.
- Performance in the listed sector has been lackluster, in part because equity investors remain underweight in real estate. Growing demand for debt enables listed firms to issue bonds at relatively attractive prices, which makes it possible to complete deals that are accretive to earnings.
- Occupiers in all sectors remain under pressure to reduce rents in light of the weak economy, although the pace of rental decline is easing. The retail sector in particular is facing a difficult year, due to weak consumer credit conditions and rising unemployment.

Economic Environment

Europe's short-term outlook is uncertain as a result of stagnant growth and weak domestic spending. The unusually harsh winter and the precarious nature of the Greek debt-refinancing problem have served to dampen economic activity. There are positive signs – such as forward-looking measures of economic sentiment and manufacturing data – that point to faster growth in the second quarter. However, Europe's dependence on an export-led recovery remains threatened by the expensive euro. Compared to Asia and the U.S., Europe remains a laggard, constrained by tight credit markets and indebted governments.

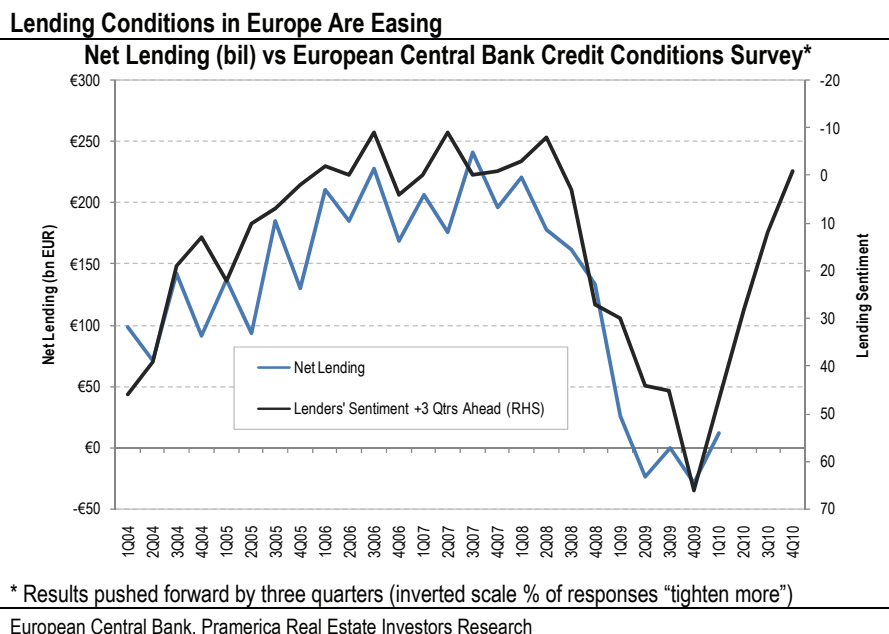
With the jury still out on the question of inflation versus deflation, the good news is that central banks remain able and willing to provide further support to buttress confidence in the financial markets. Recent bank surveys show that lending conditions will ease in the coming months. Policy rates are not expected to rise until the end of the year or early next year. GDP in Europe as a whole is expected to expand by over 1% in 2010, with faster growth coming out of central and eastern Europe and the Nordics.

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Debt Markets

Credit conditions remain tight, seemingly tied to the estimated €1 trillion of commercial real estate debt currently held on bank balance sheets. About half of that debt rolls over during the next three years, according to CBRE. Many loans originated during the recent boom years are overleveraged or are in violation of loan-to-value (LTV) covenants, which means that banks have a lot of work to go through their loan books and repair troubled loans. Some fear that if too many banks liquidate distressed assets at the same time, it could cause a double dip in European property values.



Banks' intentions remain difficult to read. Proposed solutions, which include government guarantees and good bank/bad bank models, muddy the water because they bring political pressure into the equation. But banks by-and-large are looking for a long-term strategic solution rather than a quick-fix. In the UK, for example, the largest banks are sifting through individual loans. Performing loans with high (but now improving) loan-to-value ratios are being kept on the books, as long as debt-service is being paid. Non-performing loans or those struggling to meet interest coverage are either being considered as opportunities for co-investment with third party investors, or are being sold or written off. The problem is sizeable. According to CBRE and the European Central Bank (ECB), about 20% of European commercial real estate debt is held against non-income producing assets such as unfinished development or land. Loans that are non-performing or produce no income, particularly those involving cross-border assets, will be first in line to be disposed by banks. However, demand for such assets is low, so any sales would come at steep discounts and would be unlikely to have much impact on wider market values.

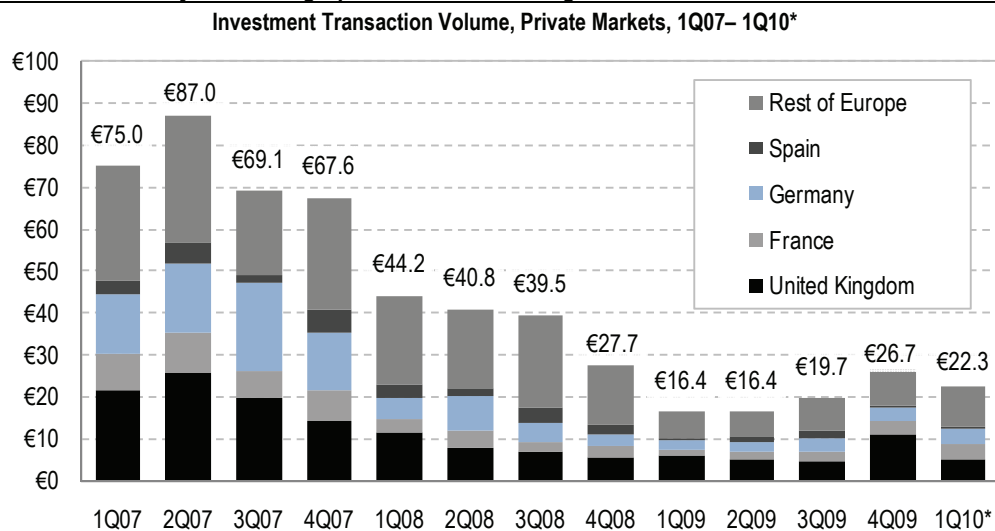
The lack of aggressive bank action to date leaves investors wondering whether banks are planning for a property market recovery or patiently preparing to sell large chunks of debt wholesale. Some analysts predict that the debt problem will be a ticking time bomb this year as a result of the large volume of distressed asset sales. Yet some opportunistic funds are disappointed at the lack of discounted real estate coming to market. According to DTZ, there is an estimated €116 billion of new equity scouting out

opportunities to take advantage of funding shortfalls, as a large proportion of maturing debt is likely to need some form of fresh equity injection. Banks, however, are not discounting assets to the degree that many investors anticipated. Indeed, the opportunity for investors to take advantage of widespread distress appears to have passed. According to Real Capital Analytics, distress in commercial real estate in Europe has been in sharp decline for more than a year.

Investment Activity

The inaction by banks – which effectively are the biggest real estate owners in Europe – makes it unlikely that transaction activity will recover quickly. For their part, investors remain fixed on the small and elusive prime end of core European markets. In the real estate recession in the 1990s, even after a slew of distressed sales, European bank lending was below historical averages for six years. The recovery this time round may take longer if banks do not act to resolve distress sooner.

Investment Activity is Trending Upwards from the Trough



*10-year average is €31 bil

RCA, CBRE, Pramerica Real Estate Investors Research

Nonetheless, investor activity is showing signs of recovery. The €22.3 billion of property sales in the first quarter is slightly down from the €26.7 billion in 4Q09, but investor appetite is broadening. Investor interest in “good secondary” in the UK, most notably in London, portends an improvement in risk appetite, as does a pick-up in activity in office markets across Spain, the Netherlands and Sweden.

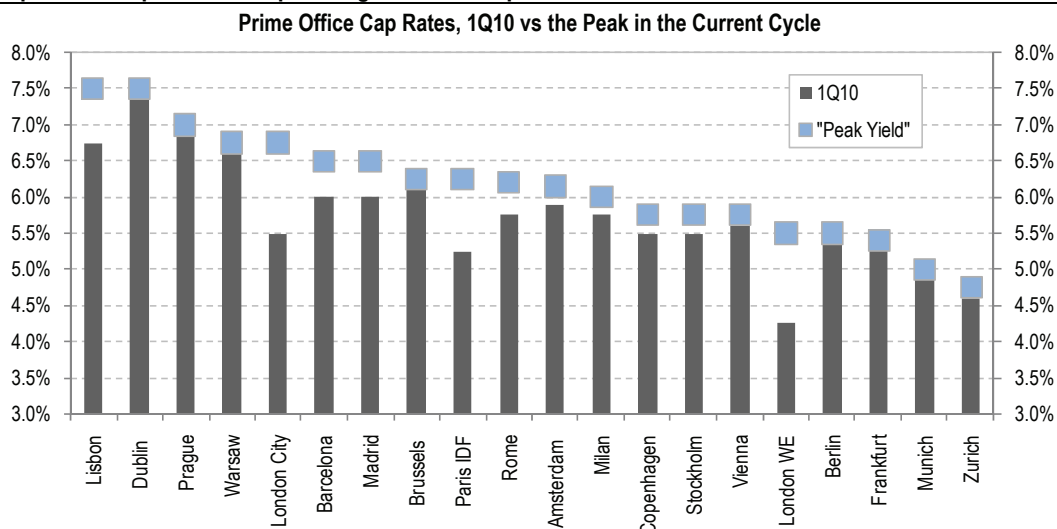
Investors are coming back to the market partly because of increasing confidence about the economy and partly to try and take advantage of property value declines in cyclical markets such as London, Paris and Madrid. The anticipated waves of occupier distress have largely been averted, although downside risks remain. Meanwhile, real estate looks historically cheap after a sharp drop in values, and it continues to offer relatively attractive returns compared with cash and gilt yields.

Improved data on capital flows and recent investor surveys by Property Market Analysis (PMA) and Investment and Pensions Europe (IPE) point to improving market sentiment. Many investors regard 2010

as a year of opportunity, and as a result capital is flowing into many funds, notably German open-end funds and the UK unlisted sector. According to the Association of Real Estate Funds, in the fourth quarter UK institutional property funds raised more than £3.2 billion (€3.6 billion or \$5.2 billion), dwarfing the previous peak of £1.7 billion (€2.5 billion or \$3.3 billion) collected in the 2006 boom. But there is still limited stock to buy. Cap rates are compressing across many markets, with one or two already approaching the lower limits of plausible fair value ranges. The majority of institutional European property funds generated positive returns in the second half of last year, according to IPD, led by the rebound in the UK commercial property market.

Transactions are dominated by cash-rich investors, leaving banks disappointed in their inability to secure lucrative prime deals. However, debt terms are easing. Spreads on five-year loans on prime properties with 70% LTVs have dropped below 200 bps over swap rates. There are also more lenders willing to provide up to €100 million of debt. According to a survey in March by UK-based advisory firm Savills, 21 European banks were willing to lend more than €30 million on a property, up from just 12 a year ago. And more banks are active in the market for smaller loans. What is particularly striking is that banks, at least officially, are again willing to provide development finance.

Cap Rate Compression is Spreading Across Europe



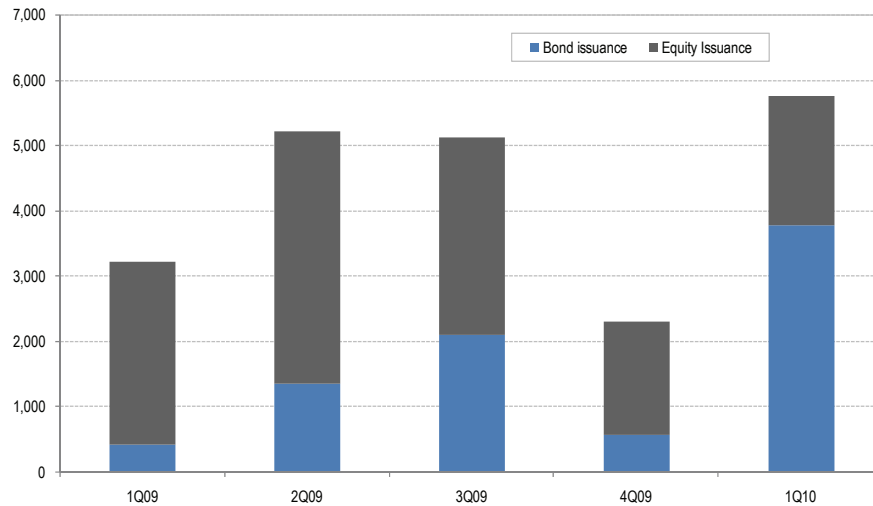
Cushman & Wakefield, CBRE, Pramerica Real Estate Research

Listed Sector

In contrast to the private markets, the public markets were relatively flat in the first quarter. The S&P BMI European Property price index fell slightly (-2.55%) while the EPRA Europe index gained 2.93%. Unlike the rally seen in the U.S., public sector prices in Europe failed to break out of trading ranges that were established by the end of 3Q09.

Public Sector is Now Tapping the Bond Markets for Capital

Capital Raised by Listed European Real Estate Companies



J.P. Morgan, Pramerica Real Estate Research

In both cost and volume terms, short interest in the sector and credit default swap spreads have normalized. Many equity fund managers are underweight real estate due to a perception that other sectors provide better growth opportunities. REITs are trading at a modest discount to net asset value (NAV) and the dividends look attractive when stacked up against government bonds or general equities.

As long as earnings yields look attractive relative to financing costs and earnings-accretive deals can be sourced, capital markets remain open to issuance. For example, Netherlands-based Corio had no trouble raising equity for its €1.3 billion purchase of the Multi shopping center portfolio. Nevertheless, equity issuance remains muted and investors have a limited appetite for blind acquisition pools.

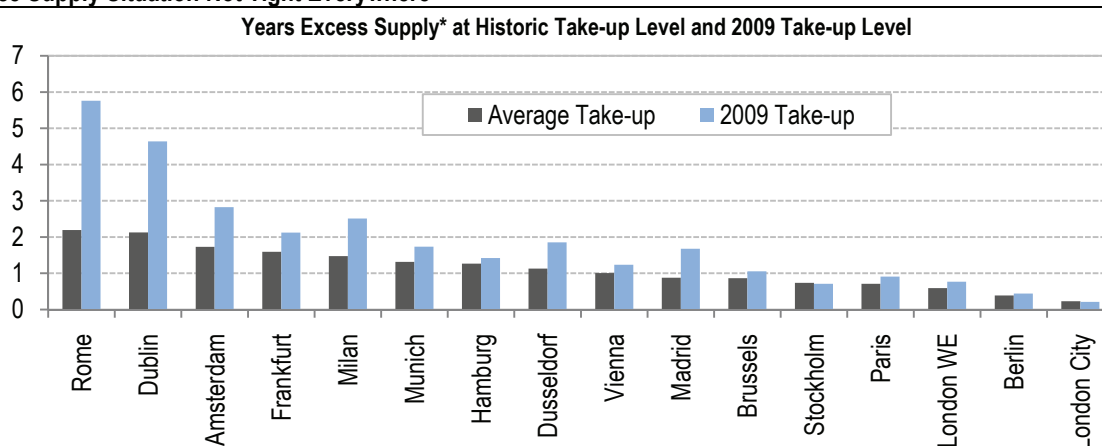
The most-notable trend this quarter has been the volume and pricing of bonds issued by listed firms. Most notably, Corio floated €900 million of seven-year bonds that were priced to yield 125 bps over swap spreads. The deal was oversubscribed by nearly threefold; such demand was unthinkable six months ago. Now that financing is available at attractive terms, listed shopping center companies are expected to be on the prowl for large acquisitions. Office players as well are running a slide rule over their development pipelines, but remain cautious on acting without partners or pre-leasing space.

Space Markets

With few exceptions, occupiers are under pressure to reduce their overheads, including rent, as margins are squeezed in the weak economy. But lease negotiations are becoming lengthier as signs of economic recovery emerge and the balance of power shifts back toward landlords. Many office market occupiers can still be characterized as downsizing or relocating to cheaper space outside of central business districts (CBDs). At the same time, the demand for logistics continues to be split. Demand for limited high quality space is resilient, while demand for second-tier properties is tepid. All retail formats are facing a rough year due to cash-constrained consumers and rising unemployment. Europe covers a wide ground so the recovery will vary on a market-by-market basis.

Office: According to flash estimates by CBRE, year-over-year headline rents continued to fall across much of Europe in 1Q10. The pace of decline is easing, notably in London, where the last two quarters have marked a sharp pick-up in demand as occupiers have looked to take advantage of historically low real rents. Outside the UK, rents are dropping in central and eastern Europe, Spain and Ireland due to weak occupier demand and relatively large increases in supply pipelines. Headline rents have remained broadly unchanged elsewhere over the past year, helped in no small part by government employment programs. But landlords in prime CBD locations continue to offer incentives by way of keeping occupiers from relocating. This is particularly the case in the larger office markets such as Amsterdam, Paris and Rome. In smaller cities, such as in Dublin, Vienna, and Barcelona, vacancy rates have been trending up as occupiers continue to look for cheaper office space. Positive rental growth is being factored in across a number of markets for 2010. On historic take-up rates, a number of markets have tight supply pipelines.

Office Supply Situation Not Tight Everywhere



*Excess supply measured as: (4Q09 Vacancy Rate – 10-Year Average)*Stock + Known Development Pipeline

PMA, Pramerica Real Estate Investors Research.

Retail: Even though retail and consumer confidence indicators are improving, 2010 looks like another difficult year for the sector. Tight credit markets, weak income growth and rising unemployment will suppress consumer spending. Nonetheless, the year-over-year pace of decline in retail rents eased across all retail formats in the first quarter. According to CBRE, prime high street rents fell most sharply in the over-supplied markets in central and eastern Europe (such as Budapest and Moscow) as well as in a number of west European cities (Dublin and Barcelona, for example) that are still reeling from the collapse in credit markets. Prime high street rents are showing greater resilience in other parts of Europe, with large retail chains taking advantage of normally limited space becoming vacant (e.g. Madrid) or due to expansion plans by international retailers (such as in Paris and Milan).

Vacancy rates continue to rise for shopping centers, although the balance of power is slowly shifting from tenants as market confidence improves and the collapse in the development pipeline helps to limit vacancy rate forecasts. The downward pressure on rents is also easing in the retail warehouse sector, as the tenant mix continues to trend away from big-ticket occupiers toward value-end retailers and grocery stores. As with other retail formats, negotiations over lease terms and conditions remain difficult and drawn out.

Logistics: According to Knight Frank, conditions are challenging as tenants continue to renegotiate leases, sublease space, consolidate their operations or relocate. As a result, landlords are offering smaller blocks of space and shorter leases to attract tenants. Yet, the pace of declines in rent is easing as the market is being stabilized by a pick-up in manufacturing activity and lack of new development. Performance varies in different parts of Europe. Rents are down the most in central and eastern Europe, where development pipelines are large, and south Europe, the UK and Ireland due to the economic malaise. Elsewhere the news is not as bad, thanks to tenant incentives in locations such as Germany, and ongoing demand for limited high quality flexible space in markets such as Oslo, Milan and Vienna. Demand for older stock has fallen sharply.

Closing Thoughts

Investor sentiment in the private markets continues to improve, despite weak economic data. Occupier markets look to have withstood the worst of the collapse in GDP growth, while shrinking development pipelines in western Europe mean even a poor employment recovery could feed through into rising headline rents by the end of the year. Yet the risks to the occupier and investor generally are weighted to the downside, particularly outside the prime sector, where banks control the fate of a large amount of stock.

Meanwhile, capital continues to flow into the sector, feeding a recovery in investment activity. It is perhaps too early to tell, but there are signs that investors are venturing further from the prime markets of the UK and France as a result of increased risk appetite. But it could also be a sign of too much cash chasing too few deals with cap rate compression starting to force investors further afield.

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