

European Quarterly

Market Perspective

Executive Summary

- The economic recovery is gaining traction across Europe, but it is not without downside risks. One particular concern is how authorities manage the gradual withdrawal of their extraordinary fiscal and monetary policies and how the private sector reacts.
- Banks are under less pressure than they were a year ago to pare their commercial real estate holdings. Partly as a result, better-capitalized banks are easing lending standards.
- An influx of cross-border, cash-rich investors are on the prowl for elusive prime real estate in core Western European markets, pushing cap rates below long-term averages. The resulting rise in prices for core properties of all types has created growing concerns that investor sentiment is getting ahead of fundamentals, which could lead to another asset bubble followed by a correction.
- Listed firms by-and-large have successfully repaired balance sheets and reduced leverage levels. Prices of REIT shares rallied strongly in 2009 and now many are looking to buy assets.
- Space markets have generally held up better than expected, given the collapse in GDP growth. With the development pipeline limited by the withdrawal of construction financing, rental rates could recover sooner than expected. One drawback to that scenario is that employers have not made substantial cuts to payrolls during the recession, and therefore may not hire robustly during the recovery.
- Transaction volume will recover somewhat in 2010, in part because investors anticipate rental growth, particularly in prime locations. However, the path will likely be bumpy.

Economic Environment

Following the largest collapse in Europe's GDP since the 1930s, the economic recovery is gaining traction. GDP growth was positive for almost every country in the third quarter. However, Europe's economies are not quite out of the woods yet. Strip out extraordinary fiscal and monetary policies and there is little evidence of a sustained pick-up in private sector activity.

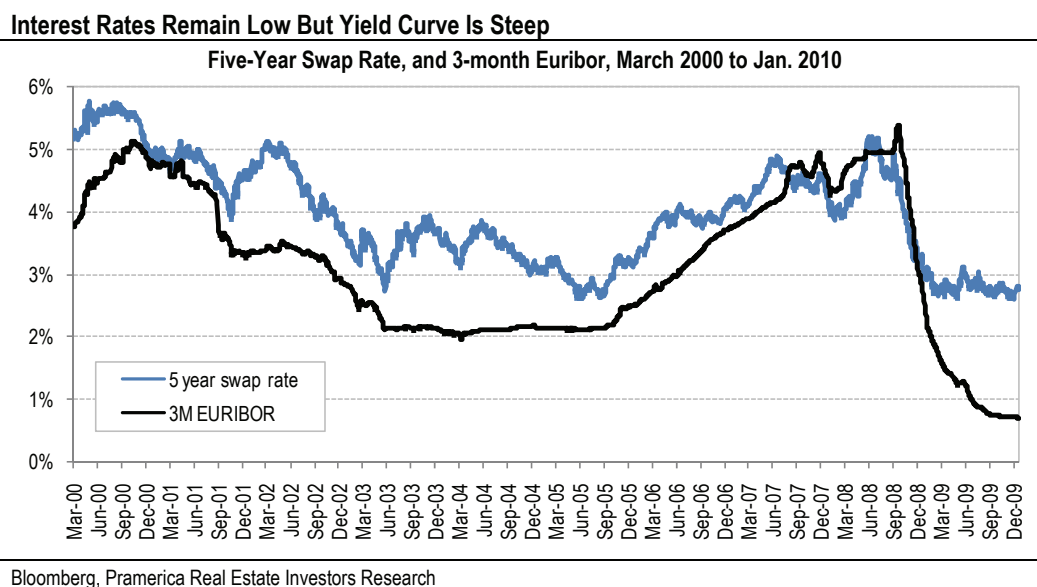
The consensus view remains that Europe's economies will slowly return to trend growth over the next few years, but there are significant downside risks. Policymakers are under growing pressure to implement credible exit strategies to pay down the growing mountain of public debt, all while tightening accommodative monetary policy to manage inflation expectations. How private sector activity responds to the changes remains a key unknown.

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Debt Markets

News is mixed in the credit markets, which are a key to the economic recovery in Europe. Interbank rates are once again hovering just above policy rates, thanks to the liquidity operations by central banks, but longer-term lending continues to carry a premium. For instance, five-year swap rate margins are still elevated at roughly 200 bps over 3-month Euribor, while the historical average is closer to 80 bps. Still, even with easy monetary policy, authorities cannot force banks to lend. Loan originations in Europe were near all-time historical lows in 2009. Nonetheless, surveys by the Bank of England and the European Central Bank, among others, suggest that credit conditions are set to ease over the next six months as banks repair balance sheets and write down asset values.



Whether a near-term easing in credit conditions leads to more commercial real estate lending is difficult to tell. European banks have collectively tightened lending standards on commercial property loans due to the credit crisis. Banks were surprised by the sudden collapse in property values, particularly in the UK, Spain and Ireland, where the proportion of commercial real estate debt held on banks' books was at a historic high (about 17% of their entire loan books as of mid-2009).

Banks remain reluctant to confront their real estate exposure. Not only do they want to avoid booking the losses, they are under no pressure to do so. Government injections of capital, variations on "bad bank" models and insurance provisions, in tandem with record low policy rates, have helped prop up the European banking sector one way or another.

The ongoing logjam in the debt markets is delaying a substantial recovery in transaction activity, and the situation is unlikely to change soon. Aside from their reluctance to sell non-performing assets at steep discounts, banks have learned from previous recessions that values can and do recover sharply. Banks are building work-out teams, particularly in the UK where the largest losses are likely, with the idea of managing distressed loans on a case-by-case basis. Banks are likely to manage many foreclosed assets and not liquidate them until the market has recovered.

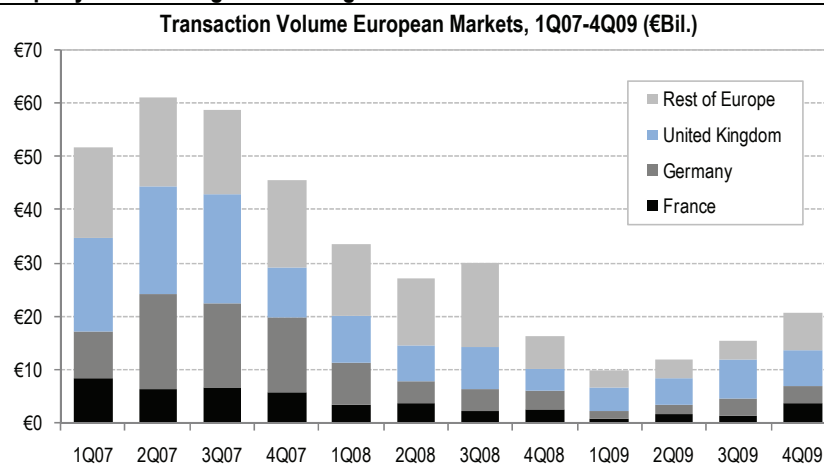
Given the amount of real estate debt still held on banks' balance sheets and the tepid economic outlook, it might seem odd that new loan terms are easing. Loan spreads nudged down in the fourth quarter to 180-220 bps, while five-year loans and large loans of €100 million or more are once again becoming achievable. What's more, margins on development projects that are pre-leased have also started to come down from 500 bps, and banks are broadening their lending beyond prime assets to so-called "good secondary" properties (which include prime real estate on short leases). Terms on which banks remain steadfast are loan-to-value ratios, which remain at about 60% on average, and debt-service ratios, which remain around 1.4 times.

The fact that banks are increasingly competing for new lending should not come as too much of a surprise. Various policy responses by authorities have reduced the risks of holding loans. Employment has broadly held up across much of Europe, and rental values have not collapsed everywhere. Indeed, in some markets such as the UK, headline rents now appear to have hit a floor. But lending on real estate at present is also attractive because of the profitable margins. The problem for banks, though, is that they are finding it difficult to secure transactions that suit their lending criteria.

Transaction Activity

The recovery of private-market transaction volume is being fueled by the dominance of cash-rich investors. Some €20 billion of deals closed in the fourth quarter, up from just over €14 billion in the third quarter. Volume is focused on prime, well-leased assets in the deep and liquid markets of Western Europe.

Property Sales Rising After Hitting Bottom

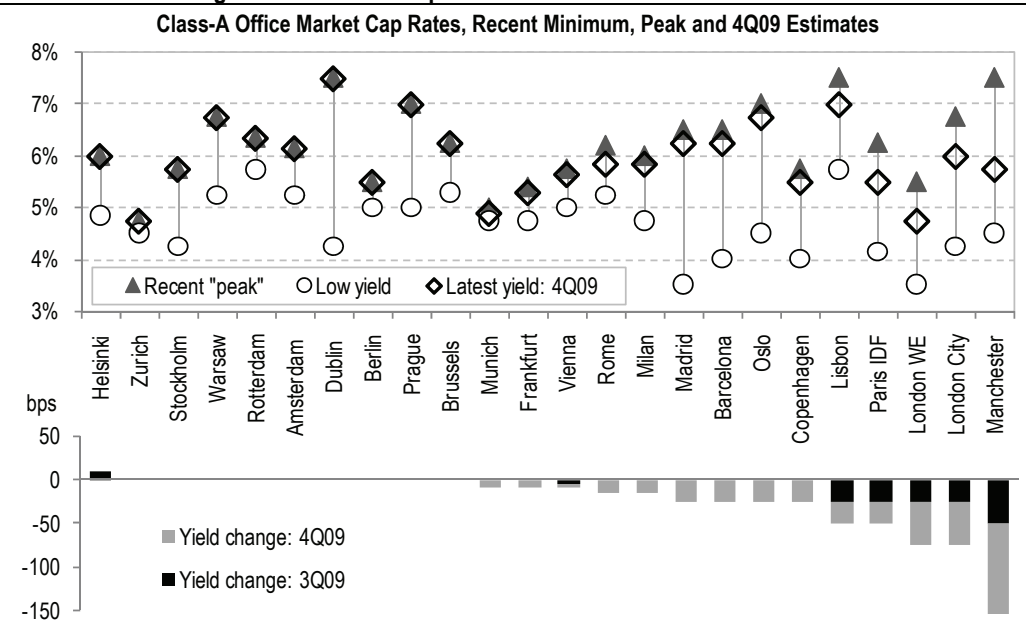


DTZ Research

In contrast to the early 1990s, when investors stayed close to home, deals are being driven by cross-border investors, many from the Middle East and Asia Pacific. But the ongoing globalization of real estate is only part of the story. Buying also is driven by the opportunity created by the sharp drop in property values and the incremental yields provided by real estate versus bonds or cash. The UK's relatively cheap exchange rate also helps to attract overseas investment and drives UK cross-border investors home.

Although the fourth-quarter volume remains small in comparison to the 10-year quarterly average of €30 billion, it signals improvement in demand, particularly for high-quality properties with secure cash flows. Since there is limited stock available for that property niche, cap rates have started to decline in many European markets, most aggressively in the UK. Based on CBRE's flash estimates for 4Q09, cap rates across much of Europe appear to be peaking *below* their long-term averages. UK office cap rates have fallen by as much as 100-150 basis points since June.

Yields are Hardening Across Some European Real Estate Markets



CBRE, Cushman & Wakefield, Pramerica Real Estate Investors Research

The speed of price adjustment, while space market fundamentals have yet to stabilize, gives rise to concern that real estate is mispriced. What's more, there are growing fears that the renewed surge in global liquidity in the sector will produce another asset bubble. Just like 2005 and 2006, some funds are under pressure to buy assets simply because they have capital to deploy. According to DTZ Research, some €110 billion (\$157 billion) of capital will be available for investment in Europe this year, and roughly the same amount will be available again in 2011. That leads to growing concern that European real estate will experience a "double-dip" drop in values because investor sentiment has moved too far ahead of fundamentals. A correction could be triggered by a flood of properties coming to market as current owners take advantage of the repricing, a rise in long-term interest rates or disappointing rental growth. There is also a danger that investors have underestimated the impact of potential funding gaps of properties whose existing debt is maturing, particularly with regard to the estimated €66 billion (\$95 billion) of CMBS that is due to mature by 2014. Distressed sales could increase as banks resolve troubled loans, most of which are backed by second-tier or worse stock.

Rising prices would not be so worrisome if the strong rental growth that is forecast for most markets comes to pass. But it is also possible that the drop in cap rates may just be a function of the relatively large amount of money chasing a limited pool of prime real estate.

The Listed Sector

The European listed real estate sector rebounded strongly from its bottom in April. According to the S&P BMI Property Total Return Index, the listed real estate sector was up 40.3% for the year. That performance is tempered by the fact that the index remains 53% below its April 2007 peak. The year had three distinct phases. The first quarter was characterized by a dramatic bear market, followed in the next two quarters by a staggering bull market as the deep discounts to net asset values from earlier in the year subsided. Stability returned in the fourth quarter, when prices were range-bound, up just 3.4%.

A Volatile But Rewarding Year



S&P BMI European Property Total Return

Most listed companies have successfully repaired balance sheets and reduced leverage, and are beginning to look at expanding once again. The European listed sector raised €11.4 billion in fresh equity via 82 offerings in 2009. But only €1.7 billion was raised in the fourth quarter, because of the holiday slowdown and the fact that listed firms are no longer under pressure to deleverage. The purpose of the capital raisings evolved over the course of the year. Early on, companies were raising money to delever and resolve covenant issues, but by the end of the year they became primarily *offensive* in nature and in a number of cases were targeted at specific investments. Unlike any time since 2007, companies are now able to articulate to investors the need for new acquisitions or to build out their development pipelines.

Space Markets

Europe's space markets, in the office sector in particular, have held up better than expected given the collapse in GDP growth. Many markets – including those in all sectors in Germany, Italy, the Netherlands and most of France – have not yet reported any significant drops in headline rents. Given the limited development pipeline, a small increase in occupier demand may be enough to produce higher headline rents. But there are significant downside risks. One is that Europe's economies have hoarded labor throughout the recession, resulting in over-employment and perhaps a false floor to retail sales growth.

Office: Government employment subsidy schemes may have benefited offices more than any other sector. Spain and Ireland are the only two countries that have had significant cuts in employment, due mainly to

the collapse in construction activity. That has created large drops in headline rents in those countries, which will be exacerbated by a large pipeline of new supply set to come online soon. Headline rents appearing to be stabilizing in the UK, despite the wider economic landscape, although free rent incentives are pronounced.

Key office markets across Western Europe, including Amsterdam, Brussels, Frankfurt, Milan, Stockholm and Vienna, reported little or no change in rents in the fourth quarter. Demand for space appears to have found a floor in these markets, with signs that tenants are relocating to prime buildings to take advantage of lower rents. Supply pipelines are also low in these markets. Rents are declining in secondary office markets and in some of Europe's peripheral economies, such as Denmark, Finland and Portugal, in part because of weaker local economic fundamentals.

Retail: Retail rents fell in the fourth quarter, according to CBRE, and the pace of decline accelerated slightly as retailers struggle with the most difficult environment in at least 20 years. Retail sales are falling in the face of rising unemployment, higher savings rates, falling consumer confidence, tight credit supply and declining house prices. New retail leasing activity was down 30% in 2009 from 2008, according to CBRE. Pronounced rental declines will continue in markets with relatively large supply pipelines, notably the UK, Italy, parts of the Nordics and Central and East Europe. Retail warehouses are suffering from a decline in demand for big ticket goods due to the subdued housing market. Landlords have been quicker to offer concessions to shopping center tenants in more-preferred retail environments.

Demand for space has held up in the best high street locations, where surviving retailers are keen to take advantage of a rare opportunity to take prime space left vacant by bankrupt retailers. That has caused suffering for secondary locations, some of which may not recover.

Logistics (warehouse): Rents fell by about 5% year-over-year in both 3Q09 and Q409, as the market struggles with a decline in road and air freight caused by the collapse in consumer spending and industrial production. Speculative supply has all but disappeared, although there is a large overhang of space across Central and East Europe that adds to the downward pressure on rents.

In general, weaker occupier demand can be tied to relatively weaker economic performance. Large year-over-year rental declines have been recorded in Spain, Ireland and the UK. Warehouse rents are also falling in countries on the periphery, such as Portugal and Greece. Demand has held up better in prime regional distribution hubs, including the major seaports of Antwerp, Hamburg, Marseille and Rotterdam.

Closing Thoughts

Although occupier markets held up remarkably well through the downturn, there is still a large amount of uncertainty as to the speed and shape of Europe's economic recovery over the coming quarters. This is in no small part due to extraordinary initiatives by the continent's fiscal and monetary authorities. Yet investor sentiment appears to have gotten ahead of itself, given that a subdued recovery in the space markets is anticipated. Cap rates are sharpening across almost all sectors and markets and now appear to be peaking below long-term averages. This is testimony to the amount of money chasing prime stock, but it also begs the question as to how representative market values are in the current climate.

Numerous downside risks to the occupier and investor outlook remain in place. Not the least is the fact that markets are perhaps being priced off short-term factors that will likely disappear once the authorities reverse policy initiatives. And yet the globalization of the commercial real estate market may produce demand from investors outside the region that would prompt property values to recover more quickly than anticipated in 2010. On balance, investor interest and transaction volumes are set to continue to recover this year. Rents may even begin to grow again, particularly in prime locations, but the path will likely not be smooth.

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