

European Quarterly

Market Perspective

Executive Summary

- Europe's economies are slowly pulling out of recession and forecasters are starting to revise growth projections upwards for 2010. While this is good news, declining GDP remains troublesome, as does the prospect of deflation. A long and drawn out recovery remains the central view.
- There are signs that stability is returning to real estate investment markets. Cap rates in prime office markets have stabilized or even fallen across Europe. Banks are sticking to conservative lending terms while mostly rolling over existing loans that mature.
- Deal flow remains subdued. Without many distressed sales, few properties are being put up for sale, and investors appear in no rush to re-enter the market.
- The listed sector has benefited from a strong run in the wider equity markets. Some larger names are now trading at a premium to NAV. However, there are still doubts as to the sustainability of the rally in the listed sector, given the weak outlook for occupier markets.
- Local market dynamics continue to play a relatively minor role when it comes to the occupier market. The wider macroeconomic landscape remains the key driver for tenant demand, although city specific stories should come to dominate as the recovery takes hold.

Economic Environment

Europe is pulling out of recession, at least technically. Following the collapse in GDP growth in the first quarter, the bounce-back has been impressive. The majority of Europe's economies are expected to record positive growth in the third quarter, and the 2010 GDP outlook has improved. The International Monetary Fund in October revised down its estimate of the global financial market losses to \$3.4 trillion, from the \$4.1 trillion predicted in April. The principal reason for the revision was the powerful rally in the equity markets, the second biggest increase in 50 years.

Yet the consensus remains that the recovery in Europe's economies will be protracted. While positive GDP growth rates are good news, the concern is that markets are ignoring the fall in the *level* of GDP. According to Eurostat, in 2Q09 the total amount of goods and services produced by the EU27 was down by almost 5% since the peak in 1Q08. This gives rise to a large amount of excess capacity across Europe, dashing hopes of a sharp pick-up in capital spending or employment, and keeping alive the fear of deflation.

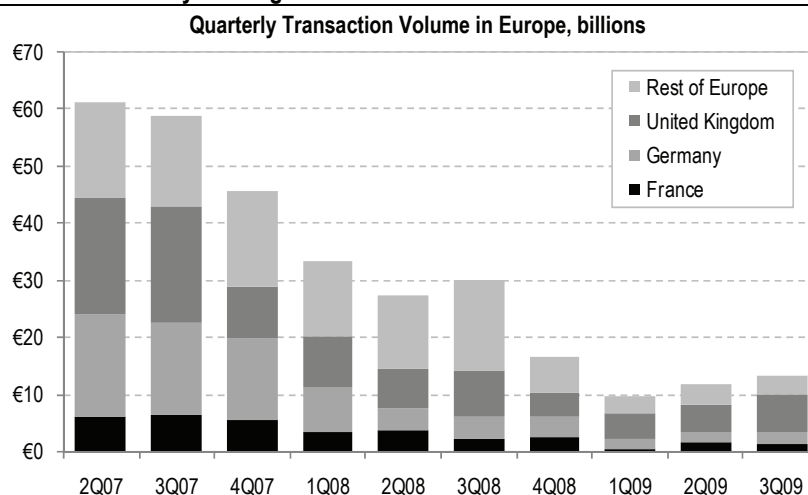
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Investment Activity

The real estate investment markets are showing signs of stability. Direct investment activity totaled €13.5 billion in the third quarter, which is the highest quarterly total this year but far below the €50 billion quarterly average in 2007, according to DTZ.

Investment Activity Starting to Rebound



DTZ, Pramerica Real Estate Investors Research

The fact that transaction activity appears to have bottomed should not come as too much of a surprise. There has been some renewed allocation to real estate as a result of the recent rally in equity markets that has eased the “denominator effect,” so institutional investors no longer must pare allocations to real estate. What is not clear is how the investment market will evolve. If history is a guide, positive year-on-year employment growth will not begin in most of Europe’s economies until 2011. This suggests that headline rents will continue to fall for another 18 months or more, and could take longer in some countries. In Italy, for example, it typically takes two years between the start of GDP growth and increased employment. In other countries, such as Spain, the pass-through has historically been much quicker.

Historical and Forecast Analysis of the Lag Between Annual Real GDP Growth and Annual Employment Growth In Select European Countries

	UK	Germany	France	Spain	Italy	N’lands	Sweden
Analysis period (no. of cycles)	1972-08 (3)	1982-08 (2)	1979-08 (3)	1977-08 (1)	1981-08 (1)	1985-08 (2)	1981-08 (3)
Forecast: Positive Annual GDP Growth	1Q10	1Q10	1Q10	3Q10	2Q10	3Q10	1Q10
Average lag to positive employment growth	5 Qtrs	3 Qtrs	4 Qtrs	2 Qtrs	7 Qtrs	4 Qtrs	3 Qtrs

Eurostat, Pramerica Real Estate Investors Research

Within the funds industry, investors feel particularly let down by factors that include the general lack of fund transparency. This might be a cyclical response to the crisis, but it could also portend significant changes to the way in which real estate funds are set up and managed. Some large institutional investors say they may

only commit to funds with a small number of like-minded investors that are managed by stable, process-driven firms with strong track records. Investors also want better risk management. All of this suggests that investors are in no rush to get back into the market. According to INREV, a trade group for investors in European real estate vehicles, only nine new funds were launched in the second quarter, down from 14 in 1Q09 and 17 in 2Q08.

Debt Markets

Another legacy of the financial crisis is the sheer scale of debt that has to be managed down by the public and private sectors. The burgeoning debt adds to the prospect of a slow recovery in real estate transaction volume, a reminder to market players to avoid letting sentiment get too far ahead of the fundamentals.

Falling asset values are pushing more loans into technical breach of loan-to-value (LTV) covenants, but banks are unwilling to deal with the problem head-on. To date, banks have preferred to roll existing loans or to “extend and pretend.” Low funding costs have enabled banks to focus more on income coverage and less on values. And thanks to low interest rates, most loans are still meeting debt-service payments. There is evidence that a growing number of loans are close to defaulting, particularly outside the prime segment. In the UK, commercial real estate values are down by about 45% since their peak in 2007, according to the monthly IPD index, and values have also fallen sharply in Ireland, Spain and France. For some banks, the real estate debt problem is simply too large to address directly. Banks hope that the market will slowly recover and they can hang on.

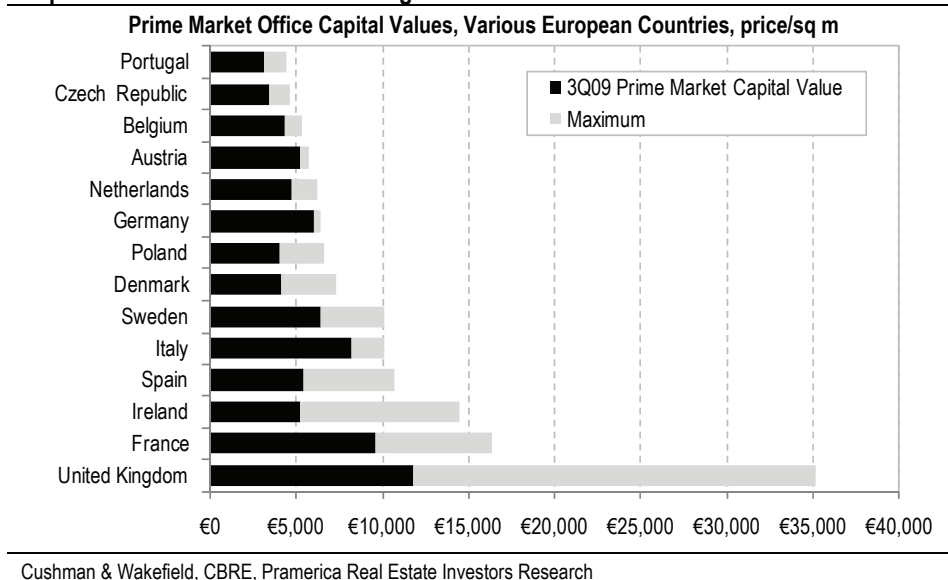
Loan terms and conditions remain as tough as they have been for the past year. The average cost of debt remains roughly 250 bps above interbank rates, with loans no higher than a 65% LTV ratio, proceeds often capped at €50 million, minimum income coverage of 1.5 times debt service and a maximum term of three years. But there are signs that more banks are willing to lend. Most of the large transactions completed in Europe this year have been financed by German banks, reflecting renewed activity in the pfandbrief market. German banks have less of a legacy issue than UK or U.S. banks, because they have always capped loans at a 65% LTV ratio, even during the heyday of excess global liquidity. According to Eurohypo, German banks could write up to €20 billion of commercial property loans in the second half of 2009, double their volume from the first half, which would give them a 30% market share of all deals.

How banks unravel their exposure to commercial real estate remains a key issue. As long as banks remain unwilling or unable to aggressively manage down their debt, the lack of distress remains a distinguishing feature of the current recession. Opportunity funds that are looking to snap up properties at significant discounts remain disappointed. Moreover, the outlook remains muddled by government programs aimed at supporting the banking sector. The Asset Protection Scheme in the UK and Ireland’s National Asset Management Agency (NAMA) are among those expected to delay the necessary deleveraging.

The overt lack of distress to date has contributed to the significant shortage of asset sales. With property values down, no one will sell unless they have to. To date, most selling has been done by either publicly-traded real estate companies or open-end funds meeting redemptions. Both types of investors are now under less pressure to sell than they were. And yet there are investors that have cash to deploy and targets to meet, although interest is concentrated in so-called “super-prime” or even “triple-A” assets. Investors are targeting the best buildings in the best locations with the best tenants, reflecting lower risk appetite by

buyers and lenders alike. Outside the prime end, very little is being traded. This is likely to continue for a while, as investors would rather wait than compromise, while owners and lenders of sub-prime also attempt to wait out the market correction.

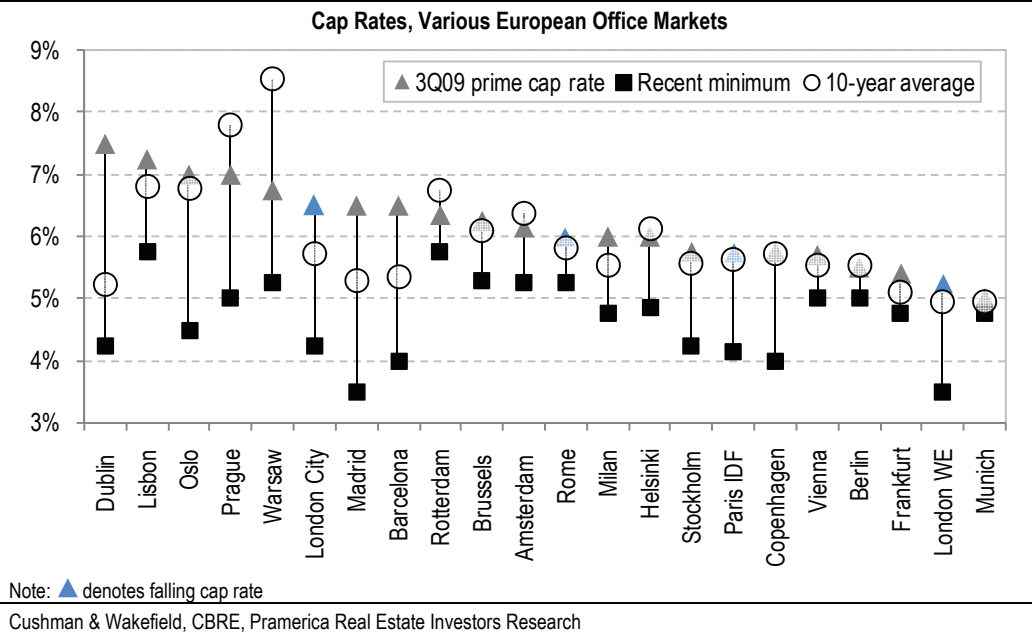
Capital Value Declines Have Been Significant



The focus on quality has drawn investors to the deep investment markets of the UK as well as Paris. On a comparative basis in terms of capital values, these markets are considered cheap. In euro terms, prime UK offices are down in value by as much as 60% from two years ago, which is attracting a lot of cross-border interest. According to DTZ, overseas buyers are responsible for about 55% of all transactions in the UK this year, well above the 10-year average of 25%. What's more, markets such as UK offices have a history of a strong recovery cycle. Indeed, there is growing belief that within the next two to three years rents will pick up sharply in Europe, thanks to a collapse in development activity. At the moment, though, investors prefer to focus on well-leased properties with strong covenants or multi-tenanted assets with low void risk.

It is hard to say how long investors will remain focused only on the cream of the crop. Nonetheless, brokers are reporting a stabilization of cap rates, even a hardening across markets. The lack of stock lies behind the numbers. For investors to move away from "super-prime" properties, bid-ask spreads need to narrow or values of non-prime assets must fall further. According to a recent bank-lending report by BNP Paribas Real Estate, this might happen sooner than later. It is possible that banks will be more proactive in managing down their debt once values stop falling, leading to renewed investor interest in non-prime assets. The risk is that if banks deluge the market with property sales, values will have to fall a lot further to attract buyers, particularly outside of the prime markets.

Cap Rate Correction Nearing an End?



Listed Sector

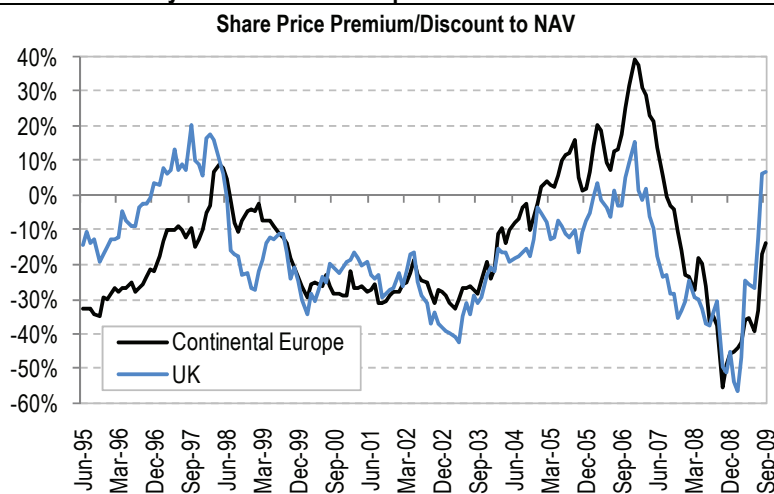
The improvement in sentiment for prime, income-producing real estate has not been lost on publicly traded companies. But they have also benefited from the wider rally in the equity markets as a whole.

According to the S&P BMI Property Total Return Index for Europe, in local currency terms, the listed real estate sector was up 34.4% in the third quarter, and 32.8% year-to-date. This is a remarkable turnaround in performance, given the slump in returns over the past two years. According to JP Morgan, the rally in public real estate between March and the end of September was the strongest in 34 years. But the index, in price terms, is still 59% below its April 2007 peak.

Over the last quarter there has been little to differentiate the performance of the listed companies in terms of the quality of their underlying property holdings. What *has* continued to have a bearing on performance is the state of company finances. The amount of debt that companies hold on their balance sheets remains a problem, but this quarter less well-capitalized companies have benefited relative to their better capitalized peers as market concerns surrounding further valuation declines have eased.

Companies with higher cash-flow yields performed better in the third quarter, on average, than those without. The larger companies by gross asset value have been quick to take advantage of improved sentiment by selling assets and raising fresh capital to pay down debt as well as to take advantage of a better outlook for the direct side. A significant number of the larger companies are now trading at a premium to NAV for the first time in over two years.

Listed Sector Rally Has Closed NAV Gap



UBS, Pramerica Real Estate Investors Research

There are still doubts as to the sustainability of the rally, given the outlook for occupier markets. However, publicly traded companies still offer better liquidity and transparency than private vehicles. Furthermore, the cost of capital for publicly traded real estate companies is far lower than that of private market competitors – where capital is difficult to come by. Public companies proven ability to access the public capital markets positions them well to take advantage of attractive opportunities in the direct (private) market. There are also elements to suggest that the listed sector has already borne the brunt of the crisis, although any downturn in wider equity markets will always pose a risk to share prices.

Space Markets

That most of Europe's economies contracted at the end of 2008 and early 2009, tipping them into recession, demonstrates that local market dynamics continue to play a relatively minor role when it comes to the occupier market. At the moment, markets with the highest headline rents are reporting the sharpest rent declines across all formats. When the economic recovery takes hold, city-specific stories will come to dominate.

Offices: Given the wider macroeconomic context, it is no surprise that headline rental values continued to drop in all of Europe's office markets in 3Q09. According to CBRE, rents fell on average by about 10% year-over-year, with the most-pronounced declines in more expensive markets and those with large volumes of new supply coming to market. Significant rental deteriorations in London, Moscow, Paris, Dublin and Madrid continue to dominate the headlines. Nonetheless, the pressure is on tenants to reduce costs, renegotiate leases or relocate to cheaper non-CBD locations. Employment intentions are still sharply down across Europe. Markets that have reported a less-severe slippage in rents, notably those across Germany, Italy and Austria, have not been as hard-hit by the recession. This may well change as various government stimulus packages helping to stave off job losses across core Europe run their course.

Retail: As with offices, the wider macroeconomic picture helps to explain relative retail performance. Global retailers scaled back expansion plans in Europe's emerging economies, while a significant increase in new supply has had a greater negative impact on the consumer-led economies such as the UK and Spain.

Rents in prime high street retail stock have remained stable due to a lack of supply, but secondary high street has suffered rising vacancy rates.

Rental rates in retail warehousing have not held up as well as might be expected, given that rents are so much lower than the other formats. Shopping centers have been more successful in offering deep concessions, particularly in out-of-town locations, helping to sustain occupier demand. With the balance of power continuing to shift to the occupier from the landlord, concessions are likely to continue. The shopping center development pipeline remains pronounced, particularly in France, Italy and Spain, despite new supply being revised downwards as developers shelve plans due to financial difficulties. Headline rents will remain under pressure in Europe for at least another 18 months.

Industrial: According to CBRE, industrial headline rents fell by almost 5% year-over-year in Europe in the third quarter, but wide differences persist across the continent. Markets in Germany, North Italy, and the Netherlands are bucking the trend with unchanged rents, reflecting their status as regional hubs. The bounce-back in quarterly GDP growth for France and Germany has also helped boost occupier demand. Outside of key distribution hubs and ports, businesses remain under pressure to cut costs, which serves to push rents down.

Industrial rents should continue to hold up in key urban locations and seaports where there is a lack of supply. Elsewhere, rents are expected to keep falling, reflecting the weak outlook for international trade. As with the office and retail asset classes, there is upside to rental growth forecasts off the back of a limited development pipeline.

Closing Thoughts

Despite improvements in the wider economy, the European real estate market is facing difficult times. Occupier markets are under pressure while access to new debt remains difficult. Given the capital intensive nature of real estate, it is difficult to think of markets approaching anything close to normal operating conditions in the near future. And there appears to be more downside than upside risk to the real estate market as a whole.

Under these conditions, the improvement in sentiment – demonstrated by the rally in public markets and increase in investor activity – is striking. There are even some parallels between now and 2005 or 2006, when too much money was chasing too little stock. The difference is that today most investors are focused on the very best stock, which is arguably the reason that the IPD UK Pooled Property Funds Indices in 3Q09 reported their first positive quarterly returns in more than two years. A few are taking a more opportunistic tack, looking to buy into a strong rental recovery in overly “cheap” markets. This would involve going outside of the prime segment into markets that face a much greater threat of falling values, a strategy that would be more viable if banks decide to become more active in managing down their debt.

How the European investment market evolves over the next few quarters remains inextricably tied up with the status of distress. Banks, at least officially, are in no hurry to force sales, while owners are in no hurry to sell. Unless this changes to a large degree, transaction activity will likely only recover in line with market fundamentals, and value corrections will remain muted.

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